

IASB documents published to accompany**International Financial Reporting Standard 4****Insurance Contracts**

The text of the unaccompanied IFRS 4 is contained in Part A of this edition. Its effective date, when issued, was 1 January 2005. The effective date of the most recent amendments is 1 January 2013. This part presents the following accompanying documents:

APPROVAL BY THE BOARD OF IFRS 4 ISSUED IN MARCH 2004

**APPROVAL BY THE BOARD OF *FINANCIAL GUARANTEE CONTRACTS*
(AMENDMENTS TO IAS 39 AND IFRS 4) ISSUED IN AUGUST 2005**

BASIS FOR CONCLUSIONS

DISSENTING OPINIONS

IMPLEMENTATION GUIDANCE

Approval by the Board of IFRS 4 issued in March 2004

International Financial Reporting Standard 4 *Insurance Contracts* was approved for issue by eight of the fourteen members of the International Accounting Standards Board. Professor Barth and Messrs Garnett, Gélard, Leisenring, Smith and Yamada dissented. Their dissenting opinions are set out after the Basis for Conclusions on IFRS 4.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Hans-Georg Bruns	
Anthony T Cope	
Robert P Garnett	
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James J Leisenring	
Warren J McGregor	
Patricia L O'Malley	
Harry K Schmid	
John T Smith	
Geoffrey Whittington	
Tatsumi Yamada	

Approval by the Board of *Financial Guarantee Contracts* (Amendments to IAS 39 and IFRS 4) issued in August 2005

Financial Guarantee Contracts (Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and to IFRS 4 *Insurance Contracts*) was approved for issue by the fourteen members of the International Accounting Standards Board.

Sir David Tweedie

Chairman

Thomas E Jones

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Mary E Barth

Hans-Georg Bruns

Anthony T Cope

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Basis for Conclusions on IFRS 4 *Insurance Contracts*

This Basis for Conclusions accompanies, but is not part of, IFRS 4.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 4 *Insurance Contracts*. Individual Board members gave greater weight to some factors than to others.

Background

- BC2 The Board decided to develop an International Financial Reporting Standard (IFRS) on insurance contracts because:
- (a) there was no IFRS on insurance contracts, and insurance contracts were excluded from the scope of existing IFRSs that would otherwise have been relevant (eg IFRSs on provisions, financial instruments and intangible assets).
 - (b) accounting practices for insurance contracts were diverse, and also often differed from practices in other sectors.
- BC3 The Board's predecessor organisation, the International Accounting Standards Committee (IASC), set up a Steering Committee in 1997 to carry out the initial work on this project. In December 1999, the Steering Committee published an *Issues Paper*, which attracted 138 comment letters. The Steering Committee reviewed the comment letters and concluded its work by developing a report to the Board in the form of a *Draft Statement of Principles* (DSOP). The Board started discussing the DSOP in November 2001. The Board did not approve the DSOP or invite formal comments on it, but made it available to the public on the IASB's Website.
- BC4 Few insurers report using IFRSs at present, although many more are expected to do so from 2005. Because it was not feasible to complete this project for implementation in 2005, the Board split the project into two phases so that insurers could implement some aspects in 2005. The Board published its proposals for phase I in July 2003 as ED 5 *Insurance Contracts*. The deadline for comments was 31 October 2003 and the Board received 135 responses. After reviewing the responses, the Board issued IFRS 4 in March 2004.
- BC5 The Board's objectives for phase I were:
- (a) to make limited improvements to accounting practices for insurance contracts, without requiring major changes that may need to be reversed in phase II.
 - (b) to require disclosure that (i) identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and (ii) helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Tentative conclusions for phase II

BC6 The Board sees phase I as a stepping stone to phase II and is committed to completing phase II without delay once it has investigated all relevant conceptual and practical questions and completed its due process. In January 2003, the Board reached the following tentative conclusions for phase II:

- (a) The approach should be an asset-and-liability approach that would require an entity to identify and measure directly the contractual rights and obligations arising from insurance contracts, rather than create deferrals of inflows and outflows.
- (b) Assets and liabilities arising from insurance contracts should be measured at their fair value, with the following two caveats:
 - (i) Recognising the lack of market transactions, an entity may use entity-specific assumptions and information when market-based information is not available without undue cost and effort.
 - (ii) In the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more, than the entity would charge to accept new contracts with identical contractual terms and remaining maturity from new policyholders. It follows that an insurer would not recognise a net gain at inception of an insurance contract, unless such market evidence is available.
- (c) As implied by the definition of fair value:¹
 - (i) an undiscounted measure is inconsistent with fair value.
 - (ii) expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).
 - (iii) the measurement of fair value should include an adjustment for the premium that marketplace participants would demand for risks and mark-up in addition to the expected cash flows.
 - (iv) fair value measurement of an insurance contract should reflect the credit characteristics of that contract, including the effect of policyholder protections and insurance provided by governmental bodies or other guarantors.
- (d) The measurement of contractual rights and obligations associated with the closed book of insurance contracts should include future premiums specified in the contracts (and claims, benefits, expenses, and other additional cash flows resulting from those premiums) if, and only if:

¹ IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

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- (i) policyholders hold non-cancellable continuation or renewal rights that significantly constrain the insurer's ability to reprice the contract to rates that would apply for new policyholders whose characteristics are similar to those of the existing policyholders; and
 - (ii) those rights will lapse if the policyholders stop paying premiums.
 - (e) Acquisition costs should be recognised as an expense when incurred.
 - (f) The Board will consider two more questions later in phase II:
 - (i) Should the measurement model unbundle the individual elements of an insurance contract and measure them individually?
 - (ii) How should an insurer measure its liability to holders of participating contracts?
- BC7 In two areas, those tentative conclusions differ from the IASC Steering Committee's recommendations in the DSOP:
- (a) the use of a fair value measurement objective rather than entity-specific value. However, that change is not as significant as it might seem because entity-specific value as described in the DSOP is indistinguishable in most respects from estimates of fair value determined using measurement guidance that the Board has tentatively adopted in phase II of its project on business combinations.²
 - (b) the criteria used to determine whether measurement should reflect future premiums and related cash flows (paragraph BC6(d)).
- BC8 Since January 2003, constraints on Board and staff resources have prevented the Board from continuing work to determine whether its tentative conclusions for phase II can be developed into a standard that is consistent with the IASB *Framework*³ and workable in practice. The Board intends to return to phase II of the project in the second quarter of 2004. It plans to focus at that time on both conceptual and practical issues, as in any project. Only after completing its deliberations will the Board proceed with an Exposure Draft of a proposed IFRS. The Board's deliberations in all projects include a consideration of alternatives and whether those alternatives represent conceptually superior approaches to financial reporting issues. Consequently, the Board will examine existing practices throughout the world to ascertain whether any could be deemed to be a superior answer suitable for international adoption.

² The Board completed the second phase of its project on business combinations in 2008 by issuing a revised IFRS 3 *Business Combinations* and an amended version of IAS 27 *Consolidated and Separate Financial Statements*. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

³ References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

- BC9 As discussed in paragraph BC84, ED 5 proposed a 'sunset clause', which the Board deleted in finalising the IFRS. Although respondents generally opposed the sunset clause, many applauded the Board's signal of its commitment to complete phase II without delay.

Scope

- BC10 Some argued that the IFRS should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They noted that regulatory requirements, and some national accounting requirements, often cover all aspects of an insurer's business. However, for the following reasons, the IFRS deals with insurance contracts of all entities and does not address other aspects of accounting by insurers:
- (a) It would be difficult, and perhaps impossible, to create a robust definition of an insurer that could be applied consistently from country to country. Among other things, an increasing number of entities have major activities in both insurance and other areas.
 - (b) It would be undesirable for an insurer to account for a transaction in one way and for a non-insurer to account in a different way for the same transaction.
 - (c) The project should not reopen issues addressed by other IFRSs, unless specific features of insurance contracts justify a different treatment. Paragraphs BC166–BC180 discuss the treatment of assets backing insurance contracts.

Definition of insurance contract

- BC11 The definition of an insurance contract determines which contracts are within the scope of IFRS 4 rather than other IFRSs. Some argued that phase I should use existing national definitions of insurance contracts, on the following grounds:
- (a) Before phase II gives guidance on applying IAS 39 *Financial Instruments: Recognition and Measurement*⁴ to difficult areas such as discretionary participation features and cancellation and renewal rights, it would be premature to require insurers to apply IAS 39 to contracts that contain these features and rights.
 - (b) The definition adopted for phase I may need to be amended again for phase II. This could compel insurers to make extensive changes twice in a short time.
- BC12 However, in the Board's view, it is unsatisfactory to base the definition used in IFRSs on local definitions that may vary from country to country and may not be most relevant for deciding which IFRS ought to apply to a particular type of contract.
- BC13 Some expressed concerns that the adoption of a particular definition by the IASB could lead ultimately to inappropriate changes in definitions used for other

⁴ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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purposes, such as insurance law, insurance supervision or tax. The Board emphasises that any definition used in IFRSs is solely for financial reporting and is not intended to change or pre-empt definitions used for other purposes.

BC14 Various Standards issued by IASC used definitions or descriptions of insurance contracts to exclude insurance contracts from their scope. The scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and of IAS 38 *Intangible Assets* excluded provisions, contingent liabilities, contingent assets and intangible assets that arise in insurance enterprises from contracts with policyholders. IASC used this wording when its insurance project had just started, to avoid prejudging whether the project would address insurance contracts or a broader class of contracts. Similarly, the scope of IAS 18 *Revenue* excluded revenue arising from insurance contracts of insurance enterprises.

BC15 The following definition of insurance contracts was used to exclude insurance contracts from the scope of an earlier version of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39.

An insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption.

BC16 This definition was supplemented by a statement that IAS 32 and IAS 39 did, nevertheless, apply when a financial instrument 'takes the form of an insurance contract but principally involves the transfer of financial risks.'

BC17 For the following reasons, the Board discarded the previous definition in IAS 32 and IAS 39:

- (a) The definition gave a list of examples, but did not define the characteristics of the risks that it was intended to include.
- (b) A clearer definition reduces the uncertainty about the meaning of the phrase 'principally involves the transfer of financial risks'. This will help insurers adopting IFRSs for the first-time ('first-time adopters') in 2005 and minimises the likelihood of further changes in classification for phase II. Furthermore, the previous test could have led to many contracts being classified as financial instruments even though they transfer significant insurance risk.

BC18 In developing a new definition, the Board also considered US GAAP. The main FASB statements for insurers deal with financial reporting by insurance entities and do not define insurance contracts explicitly. However, paragraph 1 of SFAS 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* states:

Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered.

BC19 Paragraph 6 of SFAS 113 applies to any transaction, regardless of its form, that indemnifies an insurer against loss or liability relating to insurance risk. The glossary appended to SFAS 113 defines insurance risk as:

The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

BC20 Having reviewed these definitions from US GAAP, the Board developed a new definition of insurance contract for the IFRS and expects to use the same definition for phase II. The following aspects of the definition are discussed below:

- (a) insurance risk (paragraphs BC21–BC24);
- (b) insurable interest (paragraphs BC25–BC29);
- (c) quantity of insurance risk (paragraphs BC30–BC37);
- (d) expiry of insurance-contingent rights and obligations (paragraphs BC38 and BC39);
- (e) unbundling (paragraphs BC40–BC54); and
- (f) weather derivatives (paragraphs BC55–BC60).

Insurance risk

BC21 The definition of an insurance contract in the IFRS focuses on the feature that causes accounting problems unique to insurance contracts, namely insurance risk. The definition of insurance risk excludes financial risk, defined using a list of risks that also appears in IAS 39's⁵ definition of a derivative.

BC22 Some contracts have the legal form of insurance contracts but do not transfer significant insurance risk to the issuer. Some argue that all such contracts should be treated as insurance contracts, for the following reasons:

- (a) These contracts are traditionally described as insurance contracts and are generally subject to regulation by insurance supervisors.
- (b) Phase I will not achieve great comparability between insurers because it will permit a diverse range of treatments for insurance contracts. It would be preferable to ensure consistency at least within a single insurer.

⁵ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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- (c) Accounting for some contracts under IAS 39⁶ and others under local GAAP is unhelpful to users. Moreover, some argued that IAS 39 contains insufficient, and possibly inappropriate, guidance for investment contracts.⁷
- (d) The guidance proposed in ED 5 on significant insurance risk was too vague, would be applied inconsistently and relied on actuarial resources in short supply in many countries.

BC23 However, as explained in the *Framework*, financial statements should reflect economic substance and not merely legal form. Furthermore, accounting arbitrage could occur if the addition of an insignificant amount of insurance risk made a significant difference to the accounting. Therefore, the Board decided that contracts described in the previous paragraph should not be treated as insurance contracts for financial reporting.

BC24 Some respondents suggested that an insurance contract is any contract under which the policyholder exchanges a fixed amount (ie the premium) for an amount payable if an insured event occurs. However, not all insurance contracts have explicit premiums (eg insurance cover bundled with some credit card contracts). Adding a reference to premiums would have introduced no more clarity and might have required more supporting guidance and explanations.

Insurable interest

BC25 In some countries, the legal definition of insurance requires that the policyholder or other beneficiary should have an insurable interest in the insured event. For the following reasons, the definition proposed in 1999 by the former IASC Steering Committee in the Issues Paper did not refer to insurable interest:

- (a) Insurable interest is defined in different ways in different countries. Also, it is difficult to find a simple definition of insurable interest that is adequate for such different types of insurance as insurance against fire, term life insurance and annuities.
- (b) Contracts that require payment if a specified uncertain future event occurs cause similar types of economic exposure, whether or not the other party has an insurable interest.

BC26 Because the definition proposed in the Issues Paper did not include a notion of insurable interest, it would have encompassed gambling. Several commentators on the Issues Paper stressed the important social, moral, legal and regulatory differences between insurance and gambling. They noted that policyholders buy insurance to reduce risk, whereas gamblers take on risk (unless they use a gambling contract as a hedge). In the light of these comments, the definition of an insurance contract in the IFRS incorporates the notion of insurable interest. Specifically, it refers to the fact that the insurer accepts risk from the

6 In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

7 'Investment contract' is an informal term referring to a contract issued by an insurer that does not expose the insurer to significant insurance risk and is therefore within the scope of IAS 39.

policyholder by agreeing to compensate the policyholder if an uncertain event adversely affects the policyholder. The notion of insurable interest also appears in the definition of financial risk, which refers to a non-financial variable not specific to a party to the contract.

- BC27 This reference to an adverse effect is open to the objections set out in paragraph BC25. However, without this reference, the definition of an insurance contract might have captured any prepaid contract to provide services whose cost is uncertain (see paragraphs BC74–BC76 for further discussion). This would have extended the meaning of the term ‘insurance contract’ too far beyond its traditional meaning.
- BC28 Some respondents to ED 5 were opposed to including the notion of insurable interest, on the following grounds:
- (a) In life insurance, there is no direct link between the adverse event and the financial loss to the policyholder. Moreover, it is not clear that survival adversely affects an annuitant. Any contract that is contingent on human life should meet the definition of insurance contract.
 - (b) This notion excludes some contracts that are, in substance, used as insurance, such as weather derivatives (see paragraphs BC55–BC60 for further discussion). The test should be whether there is a reasonable expectation of some indemnification to policyholders. A tradable contract could be brought within the scope of IAS 39.⁸
 - (c) It would be preferable to eliminate the notion of insurable interest and replace it with the notion that insurance is a business that involves assembling risks into a pool that is managed together.
- BC29 The Board decided to retain the notion of insurable interest because it gives a principle-based distinction, particularly between insurance contracts and other contracts that happen to be used for hedging. Furthermore, it is preferable to base a distinction on the type of contract, rather than the way an entity manages a contract or group of contracts. Moreover, the Board decided that it was unnecessary to refine this notion for a life insurance contract or life-contingent annuity, because such contracts typically provide for a predetermined amount to quantify the adverse effect (see paragraph B13 of the IFRS).

Quantity of insurance risk

- BC30 Paragraphs B22–B28 of Appendix B of the IFRS discuss how much insurance risk must be present before a contract qualifies as an insurance contract. In developing this material, the Board noted the conditions in US GAAP for a contract to be treated as an insurance contract. SFAS 113 requires two conditions for a contract to be eligible for reinsurance accounting, rather than deposit accounting:

⁸ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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- (a) the contract transfers significant insurance risk from the cedant to the reinsurer (which does not occur if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote); and
 - (b) either:
 - (i) there is a reasonable possibility that the reinsurer will suffer a significant loss (based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes); or
 - (ii) the reinsurer has assumed substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (and the cedant has retained only insignificant insurance risk on the reinsured portions).
- BC31 Under paragraph 8 of SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, an annuity contract is considered an insurance contract unless (a) the probability that life contingent payments will be made is remote⁹ or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant.
- BC32 The Board noted that some practitioners use the following guideline in applying US GAAP: a reasonable possibility of a significant loss is a 10 per cent probability of a 10 per cent loss. In this light, the Board considered whether it should define the amount of insurance risk in quantitative terms in relation to, for example:
- (a) the probability that payments under the contract will exceed the expected (ie probability-weighted average) level of payments; or
 - (b) a measure of the range of outcomes, such as the range between the highest and lowest level of payments or the standard deviation of payments.
- BC33 Quantitative guidance creates an arbitrary dividing line that results in different accounting treatments for similar transactions that fall marginally on different sides of the line. It also creates opportunities for accounting arbitrage by encouraging transactions that fall marginally on one side or the other of the line. For these reasons, the IFRS does not include quantitative guidance.
- BC34 The Board also considered whether it should define the significance of insurance risk by referring to materiality, which the *Framework* describes as follows. 'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.' However, a single contract, or even a single book of similar contracts, could rarely generate a loss that is material in relation to the financial statements as a whole. Therefore, the IFRS defines the significance of insurance risk in relation to the individual contract (paragraph B25). The Board had two reasons for this:

⁹ Paragraph 8 of SFAS 97 notes that the term remote is defined in paragraph 3 of SFAS 5 *Accounting for Contingencies* as 'the chance of the future event or events occurring is slight.'

- (a) Although insurers manage contracts on a portfolio basis, and often measure them on that basis, the contractual rights and obligations arise from individual contracts.
- (b) An assessment contract by contract is likely to increase the proportion of contracts that qualify as insurance contracts. If a relatively homogeneous book of contracts is known to consist of contracts that all transfer insurance risk, the Board did not intend to require insurers to examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk (paragraph B25 of the IFRS). The Board intended to make it easier, not harder, for a contract to meet the definition.

- BC35 The Board also rejected the notion of defining the significance of insurance risk by expressing the expected (ie probability-weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This notion had some intuitive appeal because it would consider both amount and probability. However, it would have meant that a contract could start as an investment contract (ie a financial liability) and become an insurance contract as time passes or probabilities are reassessed. In the Board's view, requiring continuous monitoring over the life of the contract would be too onerous. Instead, the Board adopted an approach that requires this decision to be made once only, at the inception of a contract. The guidance in paragraphs B22–B28 of the IFRS focuses on whether insured events could cause an insurer to pay additional amounts, judged contract by contract.
- BC36 Some respondents objected to ED 5's proposal that insurance risk would be significant if a single plausible event could cause a loss that is more than trivial. They suggested that such a broad notion of significant insurance risk might permit abuse. Instead, they suggested referring to a reasonable possibility of a significant loss. However, the Board rejected this suggestion because it would have required insurers to monitor the level of insurance risk continually, which could have given rise to frequent reclassifications. It might also have been too difficult to apply this notion to remote catastrophic scenarios; indeed, some respondents asked the Board to clarify whether the assessment should include such scenarios. In finalising the IFRS, the Board clarified the terminology by (a) replacing the notion of a plausible scenario with an explanation of the need to ignore scenarios that have no commercial substance and (b) replacing the term 'trivial' with the term 'insignificant'.
- BC37 Some respondents asked the Board to clarify the basis of comparison for the significance test, because of uncertainty about the meaning of the phrase 'net cash flows arising from the contract' in ED 5. Some suggested that this would require a comparison with the profit that the issuer expects from the contract. However, the Board had not intended this reading, which would have led to the absurd conclusion that any contract with a profitability of close to zero might qualify as an insurance contract. In finalising the IFRS, the Board confirmed in paragraphs B22–B28 that:

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- (a) the comparison is between the amounts payable if an insured event occurs and the amounts payable if no insured event occurs. Implementation Guidance in IG Example 1.3 addresses a contract in which the death benefit in a unit-linked contract is 101 per cent of the unit value.
- (b) surrender charges that might be waived on death are not relevant in assessing how much insurance risk a contract transfers because their waiver does not compensate the policyholder for a pre-existing risk. Implementation Guidance in IG Examples 1.23 and 1.24 is relevant.

Expiry of insurance-contingent rights and obligations

BC38 Some respondents suggested that a contract should no longer be treated as an insurance contract after all insurance-contingent rights and obligations have expired. However, this suggestion could have required insurers to set up new systems to identify these contracts. Therefore, paragraph B30 states that an insurance contract remains an insurance contract until all rights and obligations expire. IG Example 2.19 in the Implementation Guidance addresses dual-trigger contracts.

BC39 Some respondents suggested that a contract should not be regarded as an insurance contract if the insurance-contingent rights and obligations expire after a very short time. The IFRS includes material that may be relevant: paragraph B23 explains the need to ignore scenarios that lack commercial substance and paragraph B24(b) notes that there is no significant transfer of pre-existing risk in some contracts that waive surrender penalties on death.

Unbundling

BC40 The definition of an insurance contract distinguishes insurance contracts within the scope of the IFRS from investments and deposits within the scope of IAS 39.¹⁰ However, many insurance contracts contain a significant deposit component (ie a component that would, if it were a separate instrument, be within the scope of IAS 39). Indeed, virtually all insurance contracts have an implicit or explicit deposit component, because the policyholder is generally required to pay premiums before the period of risk; therefore, the time value of money is likely to be one factor that insurers consider in pricing contracts.

BC41 To reduce the need for guidance on the definition of an insurance contract, some argue that an insurer should ‘unbundle’ the deposit component from the insurance component. Unbundling has the following consequences:

- (a) The insurance component is measured as an insurance contract.
- (b) The deposit component is measured under IAS 39 at either amortised cost or fair value. This might not be consistent with the basis used for insurance contracts.

¹⁰ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

- (c) Premium receipts for the deposit component are recognised not as revenue, but rather as changes in the deposit liability. Premium receipts for the insurance element are typically recognised as revenue.
- (d) A portion of the transaction costs incurred at inception is allocated to the deposit component if this allocation has a material effect.

BC42 Supporters of unbundling deposit components argue that:

- (a) an entity should account in the same way for the deposit component of an insurance contract as for an otherwise identical financial instrument that does not transfer significant insurance risk.
- (b) the tendency in some countries for banks to own insurers (and vice versa) and the similarity of products offered by the insurance and fund management sectors suggest that insurers, banks and fund managers should account for the deposit component in a similar manner.
- (c) many groups sell products ranging from pure investments to pure insurance, with all variations in between. Unbundling would avoid sharp discontinuities in the accounting between a product that transfers just enough insurance risk to be an insurance contract, and another product that falls marginally on the other side of the line.
- (d) financial statements should make a clear distinction between premium revenue derived from products that transfer significant insurance risk and premium receipts that are, in substance, investment or deposit receipts.

BC43 The Issues Paper published in 1999 proposed that the deposit component should be unbundled if it is either disclosed explicitly to the policyholder or clearly identifiable from the terms of the contract. However, commentators on the Issues Paper generally opposed unbundling, giving the following reasons:

- (a) The components are closely interrelated and the value of the bundled product is not necessarily equal to the sum of the individual values of the components.
- (b) Unbundling would require significant and costly systems changes.
- (c) Contracts of this kind are a single product, regulated as insurance business by insurance supervisors and should be treated in a similar way for financial reporting.
- (d) Some users of financial statements would prefer that either all products are unbundled or no products are unbundled, because they regard information about gross premium inflows as important. A consistent use of a single measurement basis might be more useful as an aid to economic decisions than mixing one measurement basis for the deposit component with another measurement basis for the insurance component.

BC44 In the light of these arguments, the DSOP proposed that an insurer or policyholder should not unbundle these components. However, that was against the background of an assumption that the treatments of the two components would be reasonably similar. This may not be the case in phase I,

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because phase I permits a wide range of accounting treatments for insurance components. Nevertheless, the Board did not wish to require costly changes in phase I that might be reversed in phase II. Therefore, the Board decided to require unbundling only when it is easiest to perform and the effect is likely to be greatest (paragraphs 10–12 of the IFRS and IG Example 3 in the Implementation Guidance).

- BC45 The Board acknowledges that there is no clear conceptual line between the cases when unbundling is required and the cases when unbundling is not required. At one extreme, the Board regards unbundling as appropriate for large customised contracts, such as some financial reinsurance contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations. This may be especially important if a contract was deliberately structured to achieve a specific accounting result. Furthermore, the practical problems cited in paragraph BC43 are much less significant for these contracts.
- BC46 At the other extreme, unbundling the surrender values in a large portfolio of traditional life insurance contracts would require significant systems changes beyond the intended scope of phase I. Furthermore, failing to unbundle these contracts would affect the measurement of these liabilities, but not lead to their complete omission from the insurer's balance sheet. In addition, a desire to achieve a particular accounting result is much less likely to influence the precise structure of these transactions.
- BC47 The option for the policyholder to surrender a traditional life insurance contract at an amount that differs significantly from its carrying amount is an embedded derivative and IAS 39¹¹ would require the insurer to separate it and measure it at fair value. That treatment would have the same disadvantages, described in the previous paragraph, as unbundling the surrender value. Therefore, paragraph 8 of the IFRS exempts an insurer from applying this requirement to some surrender options embedded in insurance contracts. However, the Board saw no conceptual or practical reason to create such an exemption for surrender options in non-insurance financial instruments issued by insurers or by others.
- BC48 Some respondents opposed unbundling in phase I on the following grounds, in addition to the reasons given in paragraph BC43:
- (a) Insurance contracts are, in general, designed, priced and managed as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. In consequence, any unbundling required solely for accounting would be artificial. Insurance contracts should not be unbundled unless the structure of the contract is clearly artificial.
 - (b) Unbundling may require extensive systems changes that would increase the administrative burden for 2005 and not be needed for phase II.

¹¹ In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

- (c) There would be no need to require unbundling if the Board strengthened the liability adequacy test, defined significant insurance risk more narrowly and confirmed that contracts combined artificially are separate contracts.
- (d) The unbundling conditions in ED 5 were vague and did not explain the underlying principle.
- (e) Because ED 5 did not propose recognition criteria, insurers would use local GAAP to judge whether assets and liabilities were omitted. This would defeat the stated reason for unbundling.
- (f) If a contract is unbundled, the premium for the deposit component is recognised not as premium revenue but as a balance sheet movement (ie as a deposit receipt). Requiring this would be premature before the Board completes its project on reporting comprehensive income.

BC49 Some suggested other criteria for unbundling:

- (a) All contracts should be unbundled, or unbundling should always be permitted at least. Unbundling is required in Australia and New Zealand.
- (b) All non-insurance components (for example, service components) should be unbundled, not only deposit components.
- (c) Unbundling should be required only when the components are completely separable, or when there is an account in the name of the policyholder.
- (d) Unbundling could affect the presentation of revenue more than it affects liability recognition. Therefore, unbundling should also be required if it would have a significant effect on reported revenue and is easy to perform.

BC50 Some respondents argued that the test for unbundling should be two-sided (ie the cash flows of the insurance component and the investment component do not interact) rather than the one-sided test proposed in ED 5 (ie the cash flows from the insurance component do not affect the cash flows from the deposit component). Here is an example where this might make a difference: in some life insurance contracts, the death benefit is the difference between (a) a fixed amount and (b) the value of a deposit component (for example, a unit-linked investment). The deposit component can be measured independently, but the death benefit depends on the unit value so the insurance component cannot be measured independently.

BC51 The Board decided that phase I should not require insurers to set up systems to unbundle the products described in the previous paragraph. However, the Board decided to rely on the condition that provides an exemption from unbundling if all the rights and obligations under the deposit component are recognised. If this condition is not met, unbundling is appropriate.

BC52 Some argued that it is irrelevant whether the insurance component affects the deposit component. They suggested that a deposit component exists if the policyholder will receive a minimum fixed amount of future cash flows in the

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form of either a return of premium (if no insured event occurs) or an insurance recovery (if an insured event occurs). However, the Board noted that this focus on a single cash flow would not result in unbundling if a financial instrument and an insurance contract are combined artificially into a single contract and the cash flows from one component offset cash flows from the other component. The Board regarded that result as inappropriate and open to abuse.

BC53 In summary, the Board retained the approach broadly as in ED 5. This requires unbundling if that is needed to ensure the recognition of rights and obligations arising from the deposit component and those rights and obligations can be measured separately. If only the second of these conditions is met, the IFRS permits unbundling, but does not require it.

BC54 Some respondents suggested that if a contract has been artificially separated through the use of side letters, the separate components of the contract should be considered together. The Board did not address this because it is a wider issue for the Board's possible future work on linkage (ie accounting for separate transactions that are connected in some way). The footnote to paragraph B25 refers to simultaneous contracts with the same counterparty.

Weather derivatives

BC55 The scope of IAS 39¹² previously excluded contracts that require a payment based on climatic, geological, or other physical variables (if based on climatic variables, sometimes described as weather derivatives). It is convenient to divide these contracts into two categories:

- (a) contracts that require a payment only if a particular level of the underlying climatic, geological, or other physical variables adversely affects the contract holder. These are insurance contracts as defined in the IFRS.
- (b) contracts that require a payment based on a specified level of the underlying variable regardless of whether there is an adverse effect on the contract holder. These are derivatives and the IFRS removes a previous scope exclusion to bring them within the scope of IAS 39.

BC56 The previous scope exclusion was created mainly because the holder might use such a derivative in a way that resembles the use of an insurance contract. However, the definition of an insurance contract in the IFRS now provides a principled basis for deciding which of these contracts are treated as insurance contracts and which are treated as derivatives. Therefore, the Board removed the scope exclusion from IAS 39 (see paragraph C3 of Appendix C of the IFRS). Such contracts are within the scope of the IFRS if payment is contingent on changes in a physical variable that is specific to a party to the contract, and within the scope of IAS 39 in all other cases.

BC57 Some respondents suggested that a weather derivative should be treated as:

- (a) an insurance contract if it is expected to be highly effective in mitigating an existing risk exposure.

¹² In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

(b) a derivative financial instrument otherwise.

- BC58 Some argued that some weather derivatives are, in substance, insurance contracts. For example, under some contracts, the policyholder can claim a fixed sum based on rainfall levels at the nearest weather station. The contract was purchased to provide insurance against low rainfall but was structured like this because of difficulties in measuring actual loss suffered and because of the moral hazard of having a rainfall gauge on the policyholder's property. It can reasonably be expected that the rainfall at the nearest weather station will affect the holder, but the physical variable specified in the contract (ie rainfall) is not specific to a party to the contract. Similarly, some insurers use weather derivatives as a hedge against insurance contracts they issue and view them as similar to reinsurance.
- BC59 Some suggested that weather derivatives should be excluded from the scope of the IFRS because they are tradable instruments that behave like other derivatives and have an observable market value, rather than because there is no contractual link between the holder and the event that triggers payment.
- BC60 The IFRS distinguishes an insurance contract (in which an adverse effect on the policyholder is a contractual precondition for payment) from other instruments, such as derivatives and weather derivatives (in which an adverse effect is not a contractual precondition for payment, although the counterparty may, in fact, use the instrument to hedge an existing exposure). In the Board's view, this is an important and useful distinction. It is much easier to base a classification on the terms of the contract than on an assessment of the counterparty's motive (ie hedging or trading). Consequently, the Board made no change to ED 5's proposals for the treatment of weather derivatives.

Scope exclusions

- BC61 The scope of the IFRS excludes various items that may meet the definition of insurance contracts, but are, or will be, covered by existing or proposed future IFRSs (paragraph 4). The following paragraphs discuss:
- (a) financial guarantees and insurance against credit risk (paragraphs BC62–BC68);
 - (b) product warranties (paragraphs BC69–BC72);
 - (c) accounting by policyholders (paragraph BC73); and
 - (d) prepaid service contracts (paragraphs BC74–BC76).

Financial guarantees and insurance against credit risk

- BC62 The Basis for Conclusions on IAS 39¹³ explains the reasons for the Board's conclusions on financial guarantee contracts.
- BC63–BC68 [Deleted]

¹³ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

Product warranties

- BC69 A product warranty clearly meets the definition of an insurance contract if an entity issues it on behalf of another party (such as a manufacturer, dealer or retailer). The scope of the IFRS includes such warranties.
- BC70 A product warranty issued directly by a manufacturer, dealer or retailer also meets the definition of an insurance contract. Although some might think of this as 'self-insurance', the risk retained arises from existing contractual obligations towards the customer. Some may reason that the definition of insurance contracts should exclude such direct warranties because they do not involve a transfer of risk from buyer to seller, but rather a crystallisation of an existing responsibility. However, in the Board's view, excluding these warranties from the definition of insurance contracts would complicate the definition for only marginal benefit.
- BC71 Although such direct warranties create economic exposures similar to warranties issued on behalf of the manufacturer, dealer or retailer by another party (ie the insurer), the scope of the IFRS excludes them because they are closely related to the underlying sale of goods and because IAS 37 addresses product warranties. IAS 18 deals with the revenue received for such warranties.
- BC72 In a separate project, the Board is exploring an asset and liability approach to revenue recognition. If this approach is implemented, the accounting model for these direct product warranties may change.

Accounting by policyholders

- BC73 The IFRS does not address accounting and disclosure by policyholders for direct insurance contracts because the Board does not regard this as a high priority for phase I. The Board intends to address accounting by policyholders in phase II (see IASB *Update* February 2002 for the Board's discussion of accounting by policyholders). IFRSs address some aspects of accounting by policyholders for insurance contracts:
- (a) IAS 37 addresses accounting for reimbursements from insurers for expenditure required to settle a provision.
 - (b) IAS 16 addresses some aspects of compensation from third parties for property, plant and equipment that was impaired, lost or given up.
 - (c) Because policyholder accounting is outside the scope of the IFRS, the hierarchy of criteria in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies to policyholder accounting (see paragraphs BC77–BC86).
 - (d) A policyholder's rights and obligations under insurance contracts are outside the scope of IAS 32 and IAS 39.¹⁴

¹⁴ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

Prepaid service contracts

- BC74 Some respondents noted that the definition proposed in ED 5 captured some prepaid contracts to provide services whose cost is uncertain. Because these contracts are not normally regarded as insurance contracts, these respondents suggested that the Board should change the definition or exclude these contracts from the scope of the IFRS. Respondents cited two specific examples.
- (a) Fixed fee service contracts if the level of service depends on an uncertain event, for example maintenance contracts if the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, although it is uncertain that the machines will actually break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than cash).
 - (b) Some car breakdown assistance if (i) each breakdown has little incremental cost because employed patrols provide most of the assistance, (ii) the motorist pays for all parts and repairs, (iii) the service provider's only responsibility is to take the car to a specified destination (eg the nearest garage, home or the original destination), (iv) the need to provide assistance (and the related cost) is known within hours and (v) the number of call-outs is limited.
- BC75 The Board saw no conceptual reason to change either the definition of insurance contracts or the scope of the IFRS in the light of the two examples cited by respondents. Paragraphs B6 and B7 of the IFRS note that complying with the IFRS in phase I is unlikely to be particularly burdensome in these two examples, for materiality reasons. The Board may need to review this conclusion in phase II.
- BC76 Some respondents argued that the proposals in ED 5 were directed primarily at entities that are generally regarded as insurers. They suggested that the Board should not impose these proposals on entities that have a relatively small amount of a given transaction type. The Board concluded that these comments were primarily about materiality. IAS 1 *Presentation of Financial Statements* and IAS 8 address materiality and the Board decided that no further guidance or specific exemption was needed in this case.

Temporary exemption from some other IFRSs

- BC77 Paragraphs 10–12 of IAS 8 specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Without changes made in the IFRS, an insurer adopting IFRSs in 2005 would have needed to assess whether its accounting policies for insurance contracts comply with these requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some insurers might have made major changes in 2005 followed by further significant changes in phase II.
- BC78 To avoid unnecessary disruption for both users and preparers in phase I that would not have eased the transition to phase II, the Board decided to limit the

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need for insurers to change their existing accounting policies for insurance contracts. The Board did this by the following measures:

- (a) creating a temporary exemption from the hierarchy in IAS 8 that specifies the criteria an entity uses in developing an accounting policy if no IFRS applies specifically to an item. The exemption applies to insurers, but not to policyholders.
- (b) limiting the impact of that exemption from the hierarchy by five specific requirements (relating to catastrophe provisions, liability adequacy, derecognition, offsetting and impairment of reinsurance assets, see paragraphs BC87–BC114).
- (c) permitting some existing practices to continue but prohibiting their introduction (paragraphs BC123–BC146).

BC79 Some respondents opposed the exemption from the hierarchy on the grounds that it would permit too much diversity and allow fundamental departures from the *Framework* that could prevent an insurer's financial statements from presenting information that is understandable, relevant, reliable and comparable. The Board did not grant the exemption from the hierarchy in IAS 8 lightly, but took this unusual step to minimise disruption in 2005 for both users (eg lack of continuity of trend data) and preparers (eg systems changes).

BC80 ED 6 *Exploration for and Evaluation of Mineral Resources* proposes a temporary exemption from paragraphs 11 and 12 of IAS 8 (ie sources of guidance), but not from paragraph 10 (ie relevance and reliability). That proposed exemption is narrower than in IFRS 4 because ED 6 leaves a relatively narrow range of issues unaddressed. In contrast, because IFRS 4 leaves many significant aspects of accounting for insurance contracts until phase II, a requirement to apply paragraph 10 of IAS 8 to insurance contracts would have had much more pervasive effects and insurers would have needed to address matters such as completeness, substance over form and neutrality.

BC81 Some suggested that the Board should specifically require an insurer to follow its national accounting requirements (national GAAP) in accounting for insurance contracts during phase I, to prevent selection of accounting policies that do not form a comprehensive basis of accounting to achieve a predetermined result ('cherry-picking'). However, defining national GAAP would have posed problems. Further definitional problems could have arisen because some insurers do not apply the national GAAP of their own country. For example, some non-US insurers with a US listing apply US GAAP. Moreover, it is unusual and, arguably, beyond the Board's mandate to impose requirements set by another body.

BC82 In addition, an insurer might wish to improve its accounting policies to reflect other accounting developments with no counterpart in national GAAP. For example, an insurer adopting IFRSs for the first time might wish to amend its accounting policies for insurance contracts for greater consistency with accounting policies that it uses for contracts within the scope of IAS 39.¹⁵

¹⁵ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

Similarly, an insurer might wish to improve its accounting for embedded options and guarantees by addressing both their time value and their intrinsic value, even if no similar improvements are made to its national GAAP.

BC83 Therefore, the Board decided that an insurer could continue to follow the accounting policies that it was using when it first applied the phase I requirements, with some exceptions noted below. An insurer could also improve those accounting policies if specified criteria are met (see paragraphs 21–30 of the IFRS).

BC84 The criteria in paragraphs 10–12 of IAS 8 include relevance and reliability. Granting an exemption from those criteria, even temporarily, is a highly unusual step. The Board was prepared to contemplate that step only as part of an orderly and relatively fast transition to phase II. Because the exemption is so exceptional, ED 5 proposed that it would apply only for accounting periods beginning before 1 January 2007. Some described this time limit as a ‘sunset clause’.

BC85 Many respondents opposed the sunset clause. They argued the following:

- (a) If the exemption expired in 2007 before phase II is in force, there would be considerable confusion, disruption and cost for both users and preparers. It would not be appropriate to penalise users and preparers if the Board does not complete phase II on time.
- (b) The sunset clause might be perceived as putting pressure on the Board to complete phase II without adequate consultation, investigation and testing.

The Board accepted the validity of these objections to the sunset clause and deleted it.

BC86 The Board decided to maintain some requirements that follow from the criteria in IAS 8. The Board acknowledges that it is difficult to make piecemeal changes to recognition and measurement practices in phase I because many aspects of accounting for insurance contracts are interrelated with aspects that will not be completed until phase II. However, abandoning these particular requirements would detract from the relevance and reliability of an insurer’s financial statements to an unacceptable degree. Moreover, these requirements are not interrelated to a great extent with other aspects of recognition and measurement and the Board does not expect phase II to reverse these requirements. The following points are discussed below:

- (a) catastrophe and equalisation provisions (paragraphs BC87–BC93)
- (b) liability adequacy (paragraphs BC94–BC104)
- (c) derecognition (paragraph BC105)
- (d) offsetting (paragraph BC106)
- (e) impairment of reinsurance assets (paragraphs BC107–BC114).

Catastrophe and equalisation provisions

BC87 Some insurance contracts expose the insurer to infrequent but severe catastrophic losses caused by events such as damage to nuclear installations or

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satellites or earthquake damage. Some jurisdictions permit or require catastrophe provisions for contracts of this type. The catastrophe provisions are generally built up gradually over the years out of the premiums received, usually following a prescribed formula, until a specified limit is reached. They are intended to be used on the occurrence of a future catastrophic loss that is covered by current or future contracts of this type. Some countries also permit or require equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims for some types of insurance contract (eg hail, credit, guarantee and fidelity insurance) using a formula based on experience over a number of years.

BC88 Those who favour recognising catastrophe or equalisation provisions as liabilities base their view on one or more of the following arguments:

- (a) Such provisions represent a deferral of unearned premiums that are designed to provide for events that are not expected, on average, to occur in any single contract period but are expected to occur over an entire cycle of several contract periods. Although contracts cover only one period in form, in substance contracts are commonly renewed, leading to pooling of risks over time rather than within a single period. Indeed, some jurisdictions make it difficult for an insurer to stop offering insurance against some forms of risk, such as hurricanes.
- (b) In some jurisdictions, an insurer is required to segregate part of the premium (the catastrophe premium). The catastrophe premium is not available for distribution to shareholders (except on liquidation) and, if the insurer transfers the contract to another insurer, it must also transfer the catastrophe premium.
- (c) In years when no catastrophe occurs (or when claims are abnormally low), such provisions portray an insurer's long-term profitability faithfully because they match the insurer's costs and revenue over the long term. Also, they show a pattern of profit similar to one obtained through reinsurance, but with less cost and administrative burden.
- (d) Such provisions enhance solvency protection by restricting the amounts distributed to shareholders and by restricting a weak company's ability to expand or enter new markets.
- (e) Such provisions encourage insurers to accept risks that they might otherwise decline. Some countries reinforce this encouragement with tax deductions.

BC89 For the following reasons, the IFRS prohibits the recognition as a liability of provisions for possible future claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions):

- (a) Such provisions are not liabilities as defined in the *Framework*, because the insurer has no present obligation for losses that will occur after the end of the current contract period. As the *Framework* states, the matching concept does not allow the recognition of items in the balance sheet that do not meet the definition of assets or liabilities. Recognising deferred credits as if they were liabilities would diminish the relevance and reliability of an insurer's financial statements.

- (b) Even if the insurance law requires an insurer to segregate catastrophe premiums so that they are not available for distribution to shareholders in any circumstances, earnings on those segregated premiums will ultimately be available to shareholders. Therefore, those segregated amounts are appropriately classified as equity, not as a liability.
- (c) Recognising such provisions obscures users' ability to examine the impact of past catastrophes and does not contribute to their analysis of an insurer's exposure to future catastrophes. Given adequate disclosure, knowledgeable users understand that some types of insurance expose an insurer to infrequent but severe losses. Moreover, the analogy with reinsurance contracts is irrelevant, because reinsurance actually changes the insurer's risk profile.
- (d) The objective of general purpose financial statements is not to enhance solvency but to provide information that is useful to a wide range of users for economic decisions. Moreover, the recognition of provisions does not, by itself, enhance solvency. However, if the objective of financial statements were to enhance solvency and such provisions were an appropriate means of enhancing solvency, it would follow that the insurer should recognise the entire provision immediately, rather than accumulating it over time. Furthermore, if catastrophes (or unusual experience) in one period are independent of those in other periods, the insurer should not reduce the liability when a catastrophe (or unusually bad experience) occurs. Also, if diversification over time were a valid basis for accounting, above-average losses in early years should be recognised as assets, yet proponents of catastrophe and equalisation provisions do not advocate this.
- (e) Recognising catastrophe or equalisation provisions is not the only way to limit distributions to shareholders. Other measures, such as solvency margin requirements and risk-based capital requirements, could play an important role. Another possibility is for an insurer to segregate a portion of its equity for retention to meet possible losses in future years.
- (f) The objective of general purpose financial statements is not to encourage or discourage particular transactions or activities, but to report neutral information about transactions and activities. Therefore, accounting requirements should not try to encourage insurers to accept or decline particular types of risks.
- (g) If an insurer expects to continue writing catastrophe cover, presumably it believes that the future business will be profitable. It would not be representationally faithful to recognise a liability for future contracts that are expected to be profitable.
- (h) There is no objective way to measure catastrophe and equalisation provisions, unless an arbitrary formula is used.

BC90 Some suggested that it is not appropriate to eliminate catastrophe and equalisation provisions in phase I as a piecemeal amendment to existing approaches. However, the Board concluded that it could prohibit these provisions without undermining other components of existing approaches.

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There is no credible basis for arguing that catastrophe or equalisation 'provisions' are recognisable liabilities under IFRSs and there is no realistic prospect that the Board will permit them in phase II. Indeed, as noted above, paragraphs 10–12 of IAS 8 require an entity to consider various criteria in developing an accounting policy for an item if no IFRS applies specifically to that item. In the Board's view, if the IFRS had not suspended that requirement, it would clearly have prohibited the recognition of such items as a liability. Accordingly, the IFRS preserves this prohibition (see paragraph 14(a) of the IFRS).

BC91 Some respondents presented additional arguments for permitting the recognition of catastrophe and equalisation provisions as a liability:

- (a) Some insurers measure insurance contracts without margins for risk, but instead recognise catastrophe or equalisation provisions. If catastrophe provisions are eliminated in phase I, this change might be partly reversed in phase II if insurers are then required to include margins for risk.
- (b) Some insurers regard these provisions as relating partly to existing contracts and partly to future contracts. Splitting these components may be difficult and involve systems changes that might not be needed in phase II.

BC92 For the following reasons, these arguments did not persuade the Board:

- (a) Present imperfections in the measurement of recognisable liabilities do not justify the recognition of other items that do not meet the definition of a liability.
- (b) Additions to these provisions are often based on a percentage of premium revenue. If the risk period has already expired, that premium does not relate to an existing contractual obligation. If the risk period has not yet fully expired, the related portion of the premium relates to an existing contractual obligation, but most existing models defer all the related premium as unearned premium, so recognising an additional provision would be double-counting (unless the contract were known to be underpriced).

BC93 Accordingly, the Board retained the proposal in ED 5 to eliminate these provisions. However, although the IFRS prohibits their recognition as a liability, it does not prohibit the segregation of a component of equity. Changes in a component of equity are not recognised in profit or loss. IAS 1 requires a statement of changes in equity.

Liability adequacy

BC94 Many existing accounting models have tests to confirm that insurance liabilities are not understated, and that related amounts recognised as assets, such as deferred acquisition costs, are not overstated. The precise form of the test depends on the underlying measurement approach. However, there is no guarantee that these tests exist everywhere and the credibility of IFRSs could suffer if an insurer claims to comply with IFRSs but fails to recognise material

and reasonably foreseeable losses arising from existing contractual obligations. To avoid this, the IFRS requires a liability adequacy test¹⁶ (see paragraphs 15–19).

- BC95 The Board's intention was not to introduce piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses remain unrecognised during phase I. With this in mind, paragraph 16 of the IFRS defines minimum requirements that an insurer's existing test must meet. If the insurer does not apply a test that meets those requirements, it must apply a test specified by the Board. To specify a test on a basis that already exists in IFRSs and minimise the need for exceptions to existing principles, the Board decided to draw on IAS 37.
- BC96 The liability adequacy test also applies to deferred acquisition costs and to intangible assets representing the contractual rights acquired in a business combination or portfolio transfer. As a result, when the Board revised IAS 36 *Impairment of Assets* in 2004, it excluded deferred acquisition costs and those intangible assets from the scope of IAS 36.
- BC97 The Board considered whether it should retain the impairment model in IAS 36 for deferred acquisition costs, and perhaps also the related insurance liabilities. However, the IAS 36 model cannot be applied to deferred acquisition costs alone, without also considering the cash flows relating to the recognised liability. Indeed, some insurers capitalise acquisition costs implicitly through deductions in the measurement of the liability. Moreover, it would be confusing and difficult to apply this model to liabilities without some re-engineering. In the Board's view, it is simpler to use a model that is designed for liabilities, namely the IAS 37 model. In practice, a re-engineered IAS 36 model and IAS 37 might not lead to very different results.
- BC98 Some respondents suggested that the Board should specify that the cash flows considered in a liability adequacy test should include the effect of embedded options and guarantees, such as guaranteed annuity rates. They expressed concerns that many national practices have not required insurers to recognise these exposures, which can be very large.
- BC99 Although the Board's objective was not to develop a detailed liability adequacy test, it observed that the size of exposures to embedded guarantees and options and the failings of many national practices in this area warranted specific requirements, even in phase I. Accordingly, the Board decided that the minimum requirements for an existing liability adequacy test should include considering cash flows resulting from embedded options and guarantees. The Board did not specify how those cash flows should be considered but noted that an insurer would consider this matter in developing disclosures of its accounting policies. If an existing liability adequacy test does not meet the minimum requirements, a comparison is made with the measurement that IAS 37 would require. IAS 37 refers to the amount that an entity would rationally pay to settle the obligation or transfer it to a third party. Implicitly, this amount would consider the possible effect of embedded options and guarantees.

¹⁶ ED 5 described this as a 'loss recognition test'.

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- BC100 ED 5 did not specify the level of aggregation for the liability adequacy test and some respondents asked the Board to clarify this. Paragraph 18 of the IFRS confirms that the aggregation requirements of the existing liability adequacy test apply if the test meets the minimum requirements specified in paragraph 16 of the IFRS. If that test does not meet those minimum requirements, there is no conceptual justification for offsetting a loss on one contract against an otherwise unrecognisable gain on another contract. However, the Board concluded that a contract-by-contract assessment would impose costs that exceed the likely benefits to users. Therefore, paragraph 18 states that the comparison is made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a portfolio. More precise definition would be difficult and is not needed, given the Board's restricted objective of ensuring at least a minimum level of testing for the limited life of phase I.
- BC101 It is beyond the scope of phase I to create a detailed accounting regime for insurance contracts. Therefore, the IFRS does not specify:
- (a) what criteria determine when existing contracts end and future contracts start.
 - (b) whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty.
 - (c) whether the liability adequacy test considers both the time value and the intrinsic value of embedded options and guarantees.
 - (d) whether additional losses recognised because of the liability adequacy test are recognised by reducing the carrying amount of deferred acquisition costs or by increasing the carrying amount of the related insurance liabilities.
- BC102 Some respondents asked the Board to clarify that no formal liability adequacy test is needed if an entity can demonstrate that its method of measuring insurance liabilities means that they are not understated. Paragraph 15 of the IFRS requires an insurer to 'assess whether its recognised insurance liabilities are adequate, using current estimates of future cash flows'. The fundamental point is that future cash flows must be considered in some way, and not merely be assumed to support the existing carrying amount. The IFRS does not specify the precise means of ensuring this, as long as the minimum requirements in paragraph 16 are met.
- BC103 Some respondents read the liability adequacy test proposed in ED 5 as requiring fair value measurement as a minimum. That was not the Board's intention. An insurer needs to refer to IAS 37 only if the minimum requirements in paragraph 16 are not met.
- BC104 Some respondents noted that many existing liability adequacy tests require measurements that do not include a risk margin. However, IAS 37 requires such a margin. To achieve consistency, these respondents suggested that a liability adequacy test under IAS 37 should also exclude these margins. The Board did not adopt this suggestion. The idea behind using IAS 37 for phase I was to take an existing measurement basis 'off the shelf' rather than create a new model.

Derecognition

- BC105 The Board identified no reasons why derecognition requirements for insurance liabilities and insurance assets should differ from those for financial liabilities and financial assets. Therefore, the derecognition requirements for insurance liabilities are the same as for financial liabilities (see paragraph 14(c) of the IFRS). However, because derecognition of financial assets is a controversial topic, the IFRS does not address derecognition of insurance assets.

Offsetting

- BC106 A cedant (ie the insurer that is the policyholder under a reinsurance contract) does not normally have a right to offset amounts due from a reinsurer against amounts due to the underlying policyholder. Normal offsetting criteria prohibit offsetting when no such right exists. When these criteria are not met, a gross presentation gives a clearer picture of the cedant's rights and obligations, and related income and expense (see paragraph 14(d) of the IFRS).

Reinsurance assets

Impairment of reinsurance assets

- BC107 ED 5 proposed that a cedant should apply IAS 36 *Impairment of Assets* to its reinsurance assets. Respondents opposed this proposal for the following reasons:
- (a) This would compel many cedants to change their accounting model for reinsurance contracts in a way that is inconsistent with the accounting for the underlying direct insurance liability.
 - (b) IAS 36 would require the cedant to address matters that are beyond the scope of phase I for the underlying direct insurance liability, such as the cash flows to be discounted, the discount rate and the approach to risk. Some saw IAS 36 as an indirect way of imposing something similar to a fair value model. There would also have been systems implications.
 - (c) Reinsurance assets are essentially a form of financial asset and should be subject, for impairment testing, to IAS 39 rather than IAS 36.
- BC108 The Board concluded that an impairment test for phase I (a) should focus on credit risk (arising from the risk of default by the reinsurer and also from disputes over coverage) and (b) should not address matters arising from the measurement of the underlying direct insurance liability. The Board decided that the most appropriate way to achieve this was an incurred loss model based on that in IAS 39 (see paragraph 20 of the IFRS).

Gains and losses on buying reinsurance

- BC109 The IFRS defines a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant. One consequence is that the level of insurance risk required to meet the definition of an insurance contract is the same for a reinsurance contract as for a direct insurance contract.

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- BC110 National accounting requirements often define reinsurance contracts more strictly than direct insurance contracts to avoid distortion through contracts that have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance). One source of such distortions is the failure to discount many non-life insurance claims liabilities. If the insurer buys reinsurance, the premium paid to the reinsurer reflects the present value of the liability and is, therefore, less than the previous carrying amount of the liability. Reporting a gain on buying the reinsurance is not representationally faithful if no economic gain occurred at that time. The accounting gain arises largely because of the failure to use discounting for the underlying liability. Similar problems arise if the underlying insurance liability is measured with excessive prudence.
- BC111 The Board decided that it would not use the definition of a reinsurance contract to address these problems because the Board found no conceptual reason to define a reinsurance contract more or less strictly than a direct insurance contract. Instead, ED 5 addressed these problems through the following proposals:
- (a) prohibiting derecognition if the liability is not extinguished (paragraphs 14(c) of the IFRS and BC105) and prohibiting the offsetting of reinsurance assets against the related direct insurance liabilities (paragraphs 14(d) of the IFRS and BC106).
 - (b) requiring unbundling in some cases (paragraphs 10–12 of the IFRS, IG Example 3 in the Implementation Guidance and paragraphs BC40–BC54).
 - (c) limiting the recognition of gains when an insurer buys reinsurance.
- BC112 Respondents to ED 5 generally opposed the proposal described in paragraph BC111(c), on the following grounds:
- (a) These piecemeal amendments to existing accounting models were beyond the scope of phase I and would require new systems that might not be needed in phase II.
 - (b) The proposals would have been difficult to apply to more complex reinsurance contracts, including excess of loss contracts and contracts that reinsure different layers of a portfolio of underlying direct insurance contracts.
 - (c) The proposals would have created inconsistencies with the measurement of the underlying direct insurance contracts.
 - (d) The artificial gain recognised at inception of some reinsurance contracts mitigates an artificial loss that arose earlier from excessive prudence or lack of discounting. If the net exposure has been reduced by reinsurance, there is no reason to continue to overstate the original liability.
 - (e) Any deferral of profit on buying reinsurance should be recognised as a liability, not as a reduction in the carrying amount of the reinsurance asset. This would permit assets and liabilities relating to the same

underlying insurance contracts to be measured on a consistent basis and would also be consistent with other accounting bases such as US GAAP.

- (f) Any restrictions in phase I should be targeted more precisely at financial reinsurance transactions (ie transactions that do not meet the definition of an insurance contract or that have significant financial components) or contracts that provide retroactive cover (ie ones that cover events that have already occurred).
- (g) The liability adequacy test and unbundling proposals would have provided sufficient safeguards against the recognition of excessive profits.

BC113 The Board considered limiting the proposed requirements to cases where significant distortions in reported profit were most likely to occur, for example retroactive contracts. However, developing such a distinction would have been time-consuming and difficult, and there would have been no guarantee of success. The Board also considered drawing on requirements in US GAAP but decided not to include detailed requirements of this kind as a temporary and only partly effective solution. The proposals in ED 5 were an attempt to develop a simpler temporary solution. The responses indicated that the proposed solution contained too many imperfections to achieve its purpose.

BC114 The Board decided to delete the proposal in ED 5 and replace it with a specific disclosure requirement for gains and losses that arose on buying reinsurance (see paragraph 37(b) of the IFRS).

Other existing practices

BC115 The IFRS does not address:

- (a) acquisition costs (paragraphs BC116–BC119);
- (b) salvage and subrogation (paragraphs BC120 and BC121); and
- (c) policy loans (paragraph BC122).

Acquisition costs

BC116 Acquisition costs are the costs that an insurer incurs to sell, underwrite and initiate a new insurance contract. The IFRS neither prohibits nor requires the deferral of acquisition costs, nor does it prescribe what acquisition costs are deferrable, the period and method of their amortisation or whether an insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. The treatment of deferred acquisition costs is an integral part of existing models and cannot be amended easily without a more fundamental review of those models in phase II.

BC117 The treatment of acquisition costs for insurance contracts in phase I may differ from the treatment of transaction costs incurred for investment contracts (ie financial liabilities). IAS 39¹⁷ requires specified transaction costs to be presented as a deduction in determining the initial carrying amount of a financial liability. The Board did not wish to create exceptions to the definition

¹⁷ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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of the transaction costs to which this treatment applies. Those costs may be defined more broadly or more narrowly than the acquisition costs that an insurer is required or permitted to defer using its existing accounting policies.

BC118 Some entities incur significant costs in originating long-term savings contracts. Some respondents argued that most, if not all, of these costs relate to the right to charge future investment management fees rather than to the financial liability that is created when the first instalment is received. They asked the Board to clarify whether the cost of originating those rights could be recognised as a separate asset rather than as a deduction in determining the initial carrying amount of the financial liability. They noted that this treatment would:

- (a) simplify the application of the effective interest method for a financial liability carried at amortised cost.
- (b) prevent the recognition of a misleading loss at inception for a financial liability that contains a demand feature and is carried at fair value. IAS 39 states that the fair value of such a liability is not less than the amount payable on demand (discounted, if applicable, from the first date when that amount could be required to be paid).

BC119 In response to these comments, the Board decided that incremental costs directly attributable to securing an investment management contract should be recognised as an asset if they meet specified criteria, and that incremental costs should be defined in the same way as in IAS 39. The Board clarified these points by adding guidance to the illustrative examples accompanying IAS 18 *Revenue*.

Salvage and subrogation

BC120 Some insurance contracts permit the insurer to sell (usually damaged) property acquired in settling the claim (ie salvage). The insurer may also have the right to pursue third parties for payment of some or all costs (ie subrogation). The Board will consider salvage and subrogation in phase II.

BC121 In the following two related areas, the IFRS does not amend IAS 37:

- (a) Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the IFRS dealing with the assets concerned (paragraphs 51 and 52 of IAS 37).
- (b) Paragraphs 53–58 of IAS 37 address reimbursements for some or all of the expenditure required to settle a provision.

The Board is working on a project to amend various aspects of IAS 37.

Policy loans

BC122 Some insurance contracts permit the policyholder to obtain a loan from the insurer. The DSOP proposed that an insurer should treat these loans as a prepayment of the insurance liability, rather than as the creation of a separate financial asset. Because the Board does not regard this issue as a priority, phase I does not address it.

Changes in accounting policies

Relevance and reliability

BC123 IAS 8 prohibits a change in accounting policies that is not required by an IFRS, unless the change will result in the provision of reliable and more relevant information. Although the Board wished to avoid imposing unnecessary changes in phase I, it saw no need to exempt insurers from the requirement to justify changes in accounting policies. Therefore, paragraph 22 of the IFRS permits an insurer to change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant and no less reliable or more reliable and no less relevant, judged by the criteria in IAS 8.¹⁸ As the Board's conclusions for phase II develop (see paragraphs BC6–BC8), they will give insurers further context for judgements about whether a change in accounting policies will make their financial statements more relevant and reliable.

BC124 The IFRS contains further specific requirements supporting paragraph 22:

- (a) paragraph 24 permits an insurer to change its accounting policies for some insurance liabilities that it designates, without satisfying the normal requirement in IAS 8 that an accounting policy should be applied to all similar items (paragraphs BC174–BC177).
- (b) paragraph 25 permits the following practices to continue but prohibits their introduction:
 - (i) measuring insurance liabilities on an undiscounted basis (paragraphs BC126 and BC127).
 - (ii) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraphs BC128–BC130).
 - (iii) using non-uniform accounting policies for the insurance contracts of subsidiaries (paragraphs BC131 and BC132).
- (c) paragraph 26 prohibits the introduction of additional prudence if an insurer already measures insurance liabilities with sufficient prudence (paragraph BC133).
- (d) paragraphs 27–29 create a rebuttable presumption against the introduction of future investment margins in the measurement of insurance contracts (paragraphs BC134–BC144).
- (e) paragraph 30 addresses 'shadow accounting' (paragraphs BC181–BC184).

¹⁸ Unlike IAS 8, paragraph 22 of the IFRS permits changes in accounting policies that make the financial statements more reliable and no less relevant. This permits improvements that make financial statements more reliable even if they do not achieve full reliability. In IAS 8 and the *Framework*, reliability is not synonymous with verifiability but includes characteristics such as neutrality and substance over form.

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- (f) paragraph 45 permits an insurer to redesignate financial assets as 'at fair value through profit or loss' when it changes its accounting policies for insurance liabilities (paragraphs BC145 and BC146).

BC125 Some respondents suggested that phase I should not permit changes in accounting policies, to prevent lack of comparability (especially within a country) and management discretion to make arbitrary changes. However, the Board decided to permit changes in accounting policies for insurance contracts if they make the financial statements more relevant and no less reliable, or more reliable and no less relevant.

Discounting

BC126 In present practice, most general insurance claims liabilities are not discounted. In the Board's view, discounting of insurance liabilities results in financial statements that are more relevant and reliable. However, because the Board will not address discount rates and the basis for risk adjustments until phase II, the Board concluded that it could not require discounting in phase I. Nevertheless, the IFRS prohibits a change from an accounting policy that involves discounting to one that does not involve discounting (paragraph 25(a)).

BC127 Some respondents to ED 5 opposed discounting for contracts in which almost all the cash flows are expected to arise within one year, on materiality and cost-benefit grounds. The Board decided to create no specific exemption for these liabilities, because the normal materiality criteria in IAS 8 apply.

Investment management fees

BC128 Under some insurance contracts, the insurer is entitled to receive a periodic investment management fee. Some suggest that the insurer should, in determining the fair value of its contractual rights and obligations, discount the estimated future cash flows at a discount rate that reflects the risks associated with the cash flows. Some insurers use this approach in determining embedded values.

BC129 However, in the Board's view, this approach can lead to results that are not consistent with a fair value measurement. If the insurer's contractual asset management fee is in line with the fee charged by other insurers and asset managers for comparable asset management services, the fair value of the insurer's contractual right to that fee would be approximately equal to what it would cost insurers and asset managers to acquire similar contractual rights.¹⁹ Therefore, paragraph 25(b) of the IFRS confirms that an insurer cannot introduce an accounting policy that measures those contractual rights at more than their fair value as implied by fees charged by others for comparable services; however, if an insurer's existing accounting policies involve such measurements, it may continue to use them in phase I.

BC130 The Board's agenda includes a project on revenue recognition.

¹⁹ This approach is consistent with the discussion of servicing rights and obligations in IAS 39.

Uniform accounting policies on consolidation

- BC131 IAS 27 *Consolidated and Separate Financial Statements* requires entities to use uniform accounting policies.²⁰ However, under current national requirements, some insurers consolidate subsidiaries without conforming the measurement of insurance liabilities using the subsidiaries' own local GAAP to the accounting policies used by the rest of the group.
- BC132 The use of non-uniform accounting policies reduces the relevance and reliability of financial statements. However, prohibiting this would force some insurers to change their accounting policies for the insurance liabilities of some subsidiaries in phase I. This could have required systems changes that might no longer be needed in phase II. Therefore, the Board decided that an insurer already using non-uniform accounting policies for insurance contracts could continue to do so in phase I. However, if an insurer already uses uniform accounting policies for insurance contracts, it could not switch to a policy of using non-uniform accounting policies (paragraph 25(c) of the IFRS).

Excessive prudence

- BC133 Insurers sometimes measure insurance liabilities on what is intended to be a highly prudent basis that lacks the neutrality required by the *Framework*. However, phase I does not define how much prudence is appropriate and cannot, therefore, eliminate excessive prudence. Consequently, the IFRS does not attempt to prohibit existing measurements of insurance liabilities that lack neutrality because of excessive prudence. Nevertheless, it prohibits the introduction of additional prudence if an insurer already measures insurance liabilities with sufficient prudence (see paragraph 26 of the IFRS). The liability adequacy test in paragraphs 15–19 addresses the converse problem of understated insurance liabilities.

Future investment margins

- BC134 In the Board's view, the cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability). Many existing measurement practices for insurance liabilities conflict with this principle because they use a discount rate based on the estimated return from the assets that are deemed to back the insurance liabilities. However, the Board concluded that it could not eliminate these practices until phase II gives guidance on discount rates and the basis for risk adjustments.
- BC135 ED 5 stated that an accounting policy change makes financial statements less relevant and reliable if it introduces a practice of including future investment margins. On the following grounds, some respondents opposed this proposal, which would have prohibited the introduction of any measurements that reflect future investment margins:

²⁰ The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011, but the accounting policy requirements were not changed.

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- (a) The proposal prejudices a phase II issue. Most actuaries and insurers believe that a fair value measure (ie one calibrated to transactions involving insurance contracts) must include some consideration of asset performance because product pricing, reinsurance and market transactions are observed to reflect this feature.
- (b) A current market rate results in more relevant and reliable information than an out-of-date discount rate prescribed by a regulator, even if the current market rate reflects expected asset returns.
- (c) Asset-based discount rates are a feature of most existing national systems, including some modern systems that use current estimates of future cash flows and current (albeit asset-based) discount rates. The prohibition proposed in ED 5 would have prevented an insurer from replacing its existing accounting policies for insurance contracts with another comprehensive basis of accounting for insurance contracts that is, in aggregate, more relevant and reliable despite the disadvantage of using an asset-based discount rate.
- (d) Because US GAAP uses an asset-based discount rate for some insurance liabilities, the prohibition would have prevented insurers from adopting US GAAP for their insurance liabilities in phase I. This would have been unfair because some insurers that have already adopted IFRSs apply US GAAP to their insurance contracts and could continue to do so in phase I.

BC136 In the light of these comments, the Board replaced the prohibition proposed in ED 5 with a rebuttable presumption, which could be overcome if the other components of a change in accounting policies increase the relevance and reliability of an insurer's financial statements sufficiently to outweigh the disadvantage of introducing the practice in question (see paragraph 28 of the IFRS for an example).

BC137 The IFRS identifies two practices that include future investment margins in the measurement of insurance liabilities: (a) using a discount rate that reflects the estimated return on the insurer's assets,²¹ (b) projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability. Some suggested that (b) should be eliminated in phase I because they regarded it as less acceptable than (a). However, the Board noted that although (b) appears more obviously incorrect than (a), these two practices have the same effect and are logically equivalent.

²¹ Some approaches attempt to find a portfolio of assets ('replicating portfolio') with characteristics that replicate the characteristics of the liability very closely. If such a portfolio can be found, it may be appropriate to use the expected return on the replicating portfolio as the discount rate for the liability, with suitable adjustments for differences in their characteristics. However, replicating portfolio approaches should not be regarded as using an asset-based discount rate because they attempt to measure the characteristics of the liability. They are not based on the characteristics of the actual assets held, which may or may not match those of the liability.

Future investment margins and embedded value

- BC138 In addition to considering asset-based discount rates in general, the Board also considered a specific measurement technique that, at least in present practice, typically reflects future investment margins, namely embedded value. Embedded value is an indirect method of measuring an insurance liability. Indirect methods measure the liability by discounting all cash flows arising from both the book of insurance contracts and the assets supporting the book, to arrive at a net measurement for the contracts and supporting assets. The measurement of the assets is then deducted to arrive at a measurement of the book of contracts.²² In contrast, direct methods measure the liability by discounting future cash flows arising from the book of insurance contracts only. If the same assumptions are made in both methods, direct and indirect methods can produce the same results.²³
- BC139 Life insurers in an increasing number of countries disclose embedded value information. Most disclose this information outside the financial statements or as supplementary information (usually unaudited), but a few use it as a measurement in their balance sheets.²⁴
- BC140 Some respondents felt that embedded value methodology is far more relevant and reliable than most local accounting methods, and insurers should be permitted to adopt it. They noted that embedded values are often an important consideration in determining prices for acquisitions of insurers and of blocks of insurance contracts. Furthermore, embedded value and similar indirect methods are often used in accounting for the insurance liabilities assumed in these acquisitions.
- BC141 For the following reasons, some suggested that phase I should prohibit embedded value measurements in the balance sheet.
- (a) Embedded value approaches are largely unregulated at present and there is diversity in their application. For example, some view the methods used to reflect risk as fairly crude, diverse and not always fully consistent with capital market prices.
 - (b) Embedded value methods today typically involve two practices whose introduction ED 5 regarded as unacceptable:
 - (i) reflecting future investment margins in the measurement of the 'embedded value' asset associated with insurance liabilities (see paragraphs BC134–BC144).

²² If embedded values are recognised in the statement of financial position, they are typically presented as two components: an insurance liability and a separate intangible asset. This is similar to the expanded presentation that the IFRS permits in a business combination or portfolio transfer.

²³ Luke N Girard, *Market Value of Insurance Liabilities: Reconciling the Actuarial Appraisal and Option Pricing Methods*, North American Actuarial Journal, Volume 4, Number 1

²⁴ IAS 1 *Presentation of Financial Statements* (as revised in 2007) replaced the term 'balance sheet' with 'statement of financial position'.

- (ii) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services (see paragraphs BC128–BC130).
 - (c) In current practice, embedded values are generally determined on a single best estimate basis that does not reflect the full range of possible outcomes. This does not generally adequately address embedded guarantees and options, such as embedded interest rate guarantees. Until recently, embedded values would have ignored these items if they were out of the money. Indeed, in some cases, they might have been ignored even if they were in the money, because of assumptions about future investment performance. More attention is now being devoted to these options and guarantees and embedded value methods may begin to address them more rigorously, but that development is not yet complete.
- BC142 However, for the following reasons, the IFRS permits continued use of embedded value measurements:
- (a) One objective of phase I is to avoid disturbing existing practice for insurance contracts, unless a change creates a significant improvement and leads in a direction consistent with the likely direction of phase II. Prohibiting the continued use of embedded values would not meet that criterion.
 - (b) Embedded value methods are based on estimates of future cash flows, not an accumulation of past transactions. The advantages of this may, in some cases, outweigh the disadvantage of including future investment margins. Therefore, eliminating embedded value methods may not result in more relevant and reliable financial statements in every case.
 - (c) Given that the Board did not prohibit asset-based discount rates for other measurements of insurance liabilities in phase I, there is no compelling reason in phase I to prohibit embedded value measurements that contain future investment margins.
 - (d) Although embedded value measurements today typically include future investment margins, some practitioners have suggested improving embedded value methods by adjusting the asset cash flows fully for risk to make them consistent with market prices.
- BC143 It follows from the Board’s conclusions on relevance and reliability (paragraphs BC123–BC125), investment management fees (paragraphs BC128–BC130) and future investment margins (paragraphs BC134–BC137) that an insurer can introduce embedded value measurements in its balance sheet only if all the following conditions are met:
- (a) the new accounting policy will result in more relevant and reliable financial statements (paragraph 22 of the IFRS). This is not an automatic decision and will depend on a comparison of the insurer’s existing accounting with the way in which it intends to apply embedded value.

- (b) this increase in relevance and reliability is sufficient to overcome the rebuttable presumption against including future investment margins (paragraph 29 of the IFRS).
- (c) the embedded values include contractual rights to future investment management fees at an amount that does not exceed their fair value as implied by a comparison with current fees charged by other market participants for similar services (paragraph 25(b) of the IFRS and paragraphs BC128–BC130).

BC144 In some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. However, in other approaches (such as most applications of embedded value), the discount rate determines the measurement of the liability directly. The Board concluded that it is highly unlikely that an insurer could overcome the rebuttable presumption in the latter case (see paragraph 29 of the IFRS).

Redesignation of financial assets

BC145 When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all financial assets as 'at fair value through profit or loss'. This permits an insurer to avoid artificial mismatches when it improves its accounting policies for insurance liabilities. The Board also decided:

- (a) not to restrict redesignation to assets backing the insurance contracts for which the accounting policies were changed. The Board did not wish to create unnecessary barriers for those insurers that wish to move to a more consistent measurement basis that reflects fair values.
- (b) not to introduce an option to reclassify financial assets as 'available for sale'.²⁵ Such reclassification would have caused changes in carrying amount to be recognised directly in equity for assets, but in profit or loss for insurance liabilities. An insurer can avoid this inconsistency by classifying the financial assets as 'at fair value through profit or loss'.

BC146 IAS 39²⁶ permits redesignation of assets in specified circumstances when an entity adopts the revised IAS 39. IFRS 1 *First-time Adoption of International Financial Reporting Standards* contains corresponding provisions for first-time adopters.

Acquisition of insurance contracts in business combinations and portfolio transfers

BC147 When an entity acquires another entity in a business combination, IFRS 3 *Business Combinations* requires the acquirer to measure at fair value the identifiable assets and liabilities acquired. Similar requirements exist under many national accounting frameworks. Nevertheless, in practice, insurers have

²⁵ IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

²⁶ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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often used an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
- (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). Life insurers often describe this intangible asset by names such as the present value of in force business (PVIF), present value of future profits (PVFP or PVP) or value of business acquired (VOBA). Similar principles apply in non-life insurance, for example if claims liabilities are not discounted.

BC148 For the following reasons, the Board decided to permit these existing practices during phase I (paragraph 31 of the IFRS):

- (a) One objective of phase I is to avoid prejudging most phase II issues and to avoid requiring systems changes for phase I that might need to be reversed for phase II. In the meantime, disclosure about the nature of, and changes in, the related intangible asset provides transparency for users.
- (b) The IFRS gives no guidance on how to determine the fair value of the insurance liabilities, because that would be premature in phase I. Thus, fair values identified during phase I might need to be changed in phase II.
- (c) It may be difficult to integrate a fair value measurement at the date of a business combination into subsequent insurance contract accounting without requiring systems changes that could become obsolete in phase II.

BC149 The intangible asset described above is generally amortised over the estimated life of the contracts. Some insurers use an interest method of amortisation, which appears appropriate for an asset that essentially comprises the present value of a set of contractual cash flows. However, it is doubtful whether IAS 38 *Intangible Assets* would have permitted its use. Therefore, the Board decided that this asset should remain outside the scope of IAS 38 and its subsequent measurement should be consistent with the measurement of the related insurance liability (paragraph 31(b) of the IFRS). Because this asset would be covered by the liability adequacy test in paragraphs 15–19, the Board also excluded it from the scope of IAS 36 *Impairment of Assets*.

BC150 IAS 36 and IAS 38 still apply to customer lists and customer relationships reflecting the expectation of contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination. An illustrative example published with IFRS 3 deals with customer relationships acquired together with a portfolio of one-year motor insurance contracts.

BC151 Measurements of the intangible asset described in paragraph BC147(b) sometimes include future investment margins. Those margins are subject to the

same requirements as future investment margins included in the measurement of the related insurance liability (see paragraphs BC134–BC144).

- BC152 In some cases, an insurer's accounting policies under previous GAAP (ie those used before it adopted IFRSs) involved measuring the intangible asset described in paragraph BC147(b) on a basis derived from the carrying amounts of other assets and liabilities. In such cases, if an entity changes the measurements of its assets and liabilities on adopting IFRSs for the first time, shadow accounting may become relevant (see paragraphs BC181–BC184 for a discussion of shadow accounting).
- BC153 Some respondents requested an exemption from fair value measurement for insurance liabilities assumed in a business combination. They argued that there is still too much uncertainty about how fair value should be defined and determined.²⁷ However, insurers have apparently been able to cope with the existing requirements in IFRSs and in national standards. The Board saw no compelling reason for a new exemption.

Discretionary participation features

- BC154 Some insurance contracts contain a discretionary participation feature as well as a guaranteed element. The insurer has discretion over the amount and/or timing of distributions to policyholders, although that discretion may be subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Distributions are typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution means that a different generation of policyholders will benefit.
- BC155 Although the issuer has contractual discretion over distributions, it is usually likely that current or future policyholders will ultimately receive some part of the accumulated surplus available, at the reporting date, for distribution to holders of contracts with discretionary participation features (ie distributable surplus). The main accounting question is whether that part of the distributable surplus is a liability or a component of equity. The Board will explore that question in phase II.
- BC156 Features of this kind are found not only in insurance contracts but also in some investment contracts (ie financial liabilities). Requiring a particular accounting treatment in phase I for investment contracts with these features would create the risk that the Board might decide on a different treatment in phase II. Furthermore, in some cases, holders of insurance contracts and investment contracts have a contractual right to share in discretionary payments out of the same pool of assets. If the Board required a particular treatment for the discretionary participation features of the investment contracts in phase I, it might prejudge the treatment of these features in insurance contracts that are linked to the same pool of assets.

²⁷ IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

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- BC157 For these reasons, the Board decided not to address most aspects of the accounting treatment of such features in phase I, in either insurance contracts or investment contracts. However, paragraphs 34 and 35 of the IFRS confirm that it is unacceptable to classify a discretionary participation feature as an intermediate category that is neither liability nor equity, because this would be inconsistent with the *Framework*. If a balance sheet item does not meet the *Framework*'s definition of, and recognition criteria for, assets or liabilities, that item is included in equity.
- BC158 Furthermore, ED 5 proposed a requirement for the issuer of an investment contract containing such a feature to recognise a liability measured at no less than the amount that would result from applying IAS 39²⁸ to the guaranteed element of the contract. Because issuers need not determine the IAS 39 measurement of the guaranteed element if the total recognised liability is clearly higher, ED 5 noted the Board's expectation that issuers would not need extensive new systems to comply with this requirement.
- BC159 Some respondents objected that determining the result of applying IAS 39 to the guaranteed element would either have virtually no effect (in which case the requirement would be unnecessary) or require extensive new systems (causing costs exceeding the likely benefit to users). In finalising the IFRS, the Board adopted a more flexible approach that limits the need for systems to apply IAS 39 to the guaranteed element alone, while still requiring some rigour to avoid the understatement of the financial liability. Specifically, paragraph 35 permits two approaches for a discretionary participation feature in a financial liability:
- (a) The issuer may classify the entire discretionary participation feature as a liability, but need not separate it from the guaranteed element (and so need not determine the result of applying IAS 39 to the guaranteed element). An issuer choosing this approach is required to apply the liability adequacy test in paragraphs 15–19 of the IFRS to the contract.
 - (b) The issuer may classify part or all of the feature as a separate component of equity. If so, the liability recognised cannot be less than the result of applying IAS 39 to the guaranteed element. The issuer need not determine that measurement if the total liability recognised is clearly higher.
- BC160 There may be timing differences between retained earnings under IFRSs and distributable surplus (ie the accumulated amount that is contractually eligible for distribution to holders of discretionary participation features). For example, distributable surplus may exclude unrealised investment gains that are recognised under IFRSs. The resulting timing differences are analogous, in some respects, to temporary differences between the carrying amounts of assets and liabilities and their tax bases. The IFRS does not address the classification of these timing differences because the Board will not determine until phase II whether the distributable surplus is all equity, all liability or part equity and part liability.

²⁸ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

- BC161 The factor that makes it difficult to determine the appropriate accounting for these features is constrained discretion, in other words, the combination of discretion and constraints on that discretion. If participation features lack discretion, they are embedded derivatives and within the scope of IAS 39.²⁹
- BC162 The definition of a discretionary participation feature does not capture an unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (as found in the contracts described in some countries as 'universal life' contracts). Some view these features as similar to discretionary participation features because crediting rates are constrained by market forces and the insurer's resources. The Board will revisit the treatment of these features in phase II.
- BC163 Some respondents asked the Board to clarify the treatment of premiums received for financial instruments containing discretionary participation features. Conceptually the premium for the guaranteed element is not revenue, but the treatment of the premium for the discretionary participation feature could depend on matters that will not be resolved until phase II. Furthermore, requiring the premium to be split could involve system changes that might become redundant in phase II. To avoid unnecessary disruption in phase I, the Board decided that entities could continue presenting premiums as revenue, with a corresponding expense representing the change in the liability.
- BC164 Conceptually, if part or all of a discretionary participation feature is classified as a component of equity, the related portion of the premium should not be included in profit or loss. However, the Board concluded that requiring each incoming premium to be split would require systems changes beyond the scope of phase I. Therefore, the Board decided that an issuer could recognise the entire premium as revenue without separating the portion that relates to the equity component. However, the Board confirmed that the portion of profit or loss attributable to the equity component is presented as an allocation of profit or loss (in a manner similar to the presentation of minority interests³⁰), not as expense or income.
- BC165 Some suggested that investment contracts containing a discretionary participation feature should be excluded from the fair value disclosure required by IAS 32.³¹ They noted both conceptual and practical problems in determining the fair value of an instrument of this kind. However, instead of creating a new exclusion from the required disclosure of fair value, the Board added new paragraph 91A to IAS 32. This extends existing requirements in IAS 32 governing those unquoted equity instruments whose fair value cannot be determined reliably.

29 In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

30 In January 2008 the IASB issued an amended IAS 27 *Consolidated and Separate Financial Statements*, which amended 'minority interests' to 'non-controlling interests'. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The term 'non-controlling interests' and the requirements for non-controlling interests were not changed.

31 In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

Issues related to IAS 39³²

Assets held to back insurance contracts

- BC166 The IFRS does not address financial or non-financial assets held by insurers to back insurance contracts. IAS 39 identifies four categories of financial asset, with three different accounting treatments. In developing IAS 39, the Board's predecessor (IASC) acknowledged that most countries had a mixed measurement model, measuring some financial assets at amortised cost and others at fair value. IASC decided to retain, but regulate and structure, the different approaches as follows:
- (a) financial assets classified as 'at fair value through profit or loss' (including all financial assets held for trading) are measured at fair value, with all changes in their fair value recognised in profit or loss. Furthermore, all derivatives are deemed to be held for trading, and hence measured at fair value, because this is the only method that provides sufficient transparency in the financial statements.
 - (b) available-for-sale assets (ie those that do not fall into any of the other categories) are measured at fair value, with changes in their fair value recognised in equity until the asset is derecognised or becomes impaired. Measurement at fair value is appropriate given that available-for-sale assets may be sold in response to, for example, changes in market prices or a liquidity shortage.
 - (c) assets with a fixed maturity may be measured at amortised cost if the entity intends to hold them to maturity and shows that it has the ability to do so. This treatment is based on the view of some that changes in market prices are irrelevant if an asset is held to maturity because those changes will reverse before maturity (unless the asset becomes impaired).
 - (d) loans and receivables are measured at amortised cost. IASC was persuaded that there are difficulties in estimating the fair value of such loans, and that further progress was needed in valuation techniques before fair value should be required.
- BC167 Some expressed concerns that accounting mismatches would arise in phase I if financial assets (particularly interest-bearing investments) held to back insurance contracts are measured at fair value under IAS 39 whilst insurance liabilities are measured on a different basis. If the insurer classifies the assets as 'available for sale', this difference in measurement basis would not affect profit or loss but it could lead to some volatility in equity. Some do not regard that

³² In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. IFRS 9, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

volatility as a faithful representation of changes in the insurer's financial position. In developing ED 5, after discussing various suggestions for reducing that volatility,³³ the Board decided:

- (a) not to relax the criteria in IAS 39 for classifying financial assets as 'held to maturity'. Relaxing those criteria would undermine the fundamental assertion that an entity has both the intent and ability to hold the assets until maturity. The Board noted that an insurer may be able to classify some of its fixed maturity financial assets as held to maturity if it intends not to sell them before maturity and, in addition to meeting the other conditions set out in IAS 39, concludes that an unexpected increase in lapses or claims would not compel it to sell those assets (except in the 'disaster scenario' discussed in IAS 39 paragraph AG21).
- (b) not to create a new category of assets carried at amortised cost: assets held to back insurance liabilities. The creation of such a category would lead to a need for arbitrary distinctions and complex attribution procedures that would not make an insurer's financial statements more relevant and reliable, and could require insurers to develop costly systems. The Board reviewed a precedent that exists in Japan for such a category, but was not persuaded that the procedures adopted there can overcome these difficulties. Moreover, if an insurer may sell assets in response to, for example, changes in market prices or a liquidity shortage, the only appropriate measurement is fair value.
- (c) not to create a new category of 'available-for-settlement' liabilities, analogous to available-for-sale assets, measured at fair value, with changes in fair value recognised in equity. The creation of such a category would make it necessary to find some basis for distinguishing between that category and the existing category of non-trading financial liabilities, or to permit a free choice of accounting treatments. The Board has identified no basis for such a distinction, nor for deciding which of these two categories would be the new residual category. Furthermore, creating such a category could require insurers to develop new systems with no certainty that those systems would be needed in phase II.

BC168 In developing ED 5, the Board concluded that the reasons given above outweigh the effects of any accounting mismatch on an insurer's reported equity. Therefore, the Board decided not to exempt insurers from these existing requirements, even temporarily.

BC169 Insurers may be particularly sensitive to equity reported in general purpose financial statements in some countries where this amount is used in assessing compliance with regulatory capital requirements. However, although insurance supervisors are important users of general purpose financial statements, those financial statements are not directed at specific needs of insurance supervisors

³³ The Board discussed this subject at its meeting in November 2002. It was also one of the major topics raised by insurance participants at two half-day sessions during the financial instruments round tables in March 2003. Before finalising ED 5, the Board discussed the subject again in April 2003.

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that other users do not share. Furthermore, supervisors generally have the power to obtain additional information that meets their specific needs. In the Board's view, creating new exemptions from IAS 39 in this area would not have been the best way to meet the common needs of users (including insurance supervisors) of an insurer's general purpose financial statements.

- BC170 Some argued that banks enjoy an 'advantage' that is not available to insurers. Under IAS 39, a bank may measure its core banking-book assets and liabilities (loans and receivables and non-trading financial liabilities) at amortised cost, whereas an insurer would have no such option for many of the assets held to back its core insurance activities. However, as noted in paragraph BC166(d), IASC permitted amortised cost measurement for loans and receivables because it had concerns about difficulties in establishing their fair value. This factor does not apply to many assets held by insurers to back insurance liabilities.
- BC171 Many of the respondents to ED 5 urged the Board to explore ways of reducing the accounting mismatch described above. The Board discussed this subject at length at all three meetings at which it discussed the responses to ED 5 before finalising the IFRS. In addition, the Board discussed it with the Standards Advisory Council. It was also raised at a meeting of the Board's Insurance Advisory Committee in September 2003, which six Board members attended together with the project staff. Individual Board members and staff also had many discussions with interested parties, including users, insurers, actuaries, auditors and regulators.
- BC172 It is important to distinguish two different types of mismatch:
- (a) *accounting mismatch* arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities.
 - (b) *economic mismatch* arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. It is worth noting that economic mismatch is not necessarily eliminated by an asset-liability management programme that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities.
- BC173 Ideally, a measurement model would report all the economic mismatch that exists and would not report any accounting mismatch. The Board considered various alternatives, observing that all had advantages and disadvantages. Some alternatives would have amended IAS 39 to extend the use of cost or amortised cost measurements. However, the Board noted the following:
- (a) Fair value is a more relevant measurement than amortised cost for financial assets that an entity might sell in response to changing market and other conditions.
 - (b) In its response to ED 5, the Association for Investment Management and Research (AIMR) strongly urged the Board not to extend the use of amortised cost in IAS 39. The AIMR is a non-profit professional

association of more than 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries.

- (c) An accounting model that measured both assets and liabilities at amounts based on current interest rates would provide information about the degree of economic mismatch. A model that measured both at historical values, or ignored the time value of money in measuring some insurance liabilities, would not. Financial analysts often observe that information about economic mismatch is very important to them.
- (d) Some suggested that insurers wish to follow a strategy that involves holding fixed maturity investments to maturity, with some flexibility to sell investments if insurance claims or lapses are unusually high. They recommended relaxing restrictions in IAS 39 so that insurers using such a strategy could use the held-to-maturity category more easily. However, in discussions with individual Board members and staff, insurers generally indicated that they also wished to keep the flexibility to make sales in the light of changing demographic and economic conditions so that they can seek the best trade-off between risk and return. That is a valid and understandable business objective, but it is difficult to argue that cost could be more relevant than fair value in such cases. Although IAS 32³⁴ requires disclosure of the fair value of financial assets carried at amortised cost, disclosure does not rectify inappropriate measurement.
- (e) Some noted that they wished to keep the flexibility to sell corporate bonds before a major downgrade occurs. They viewed the guidance in IAS 39 as restricting their ability to do this. Moreover, because a 'tainting' requirement in IAS 39 prohibits the use of the held-to-maturity category after most sales from this category, insurers are reluctant to use this classification for corporate bonds. The application guidance in IAS 39 gives examples of cases when sales of held-to-maturity investments do not 'taint' all other such investments. For example, paragraph AG22(a) of IAS 39 refers to a sale following a significant deterioration in the issuer's creditworthiness. The Board noted that some appeared to read that guidance as limited to changes in a credit rating by an external credit rating agency, although the guidance also refers to internal ratings that meet particular criteria.
- (f) The Japanese precedent mentioned in paragraph BC167(b) creates some discipline by placing restrictions on the use of amortised cost, but for systems or other reasons not all insurers in Japan adopt this approach. Furthermore, this approach permits a cost approach if the durations (ie average maturities) of insurance liabilities match those of the related assets within a specified band of 80–125 per cent. If any economic mismatch arises within that band, this approach does not recognise it. In addition, gains and losses on selling assets held at amortised cost are generally recognised immediately in profit or loss (except that some gains are deferred and amortised if sales are not compatible with the duration matching strategy).

³⁴ In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

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- (g) Some Board members and staff met representatives of major European insurers to explore the possibility of (i) extending the use of amortised cost if specified, relatively strict, criteria are met and (ii) combining that with a simplified attempt to identify 'ineffectiveness' resulting from the fact that the assets and liabilities would not respond identically to changes in interest rates. This approach would have avoided some of the practical and conceptual problems inherent in the Japanese approach discussed above. However, this untried approach had been developed at short notice and not all details had been worked through. Moreover, many insurers may not be able or willing to invest in systems that could need amendment in phase II.
 - (h) That a mixed measurement model can create an accounting mismatch is undeniable. Furthermore, it costs time and money for insurers to explain the effects even to sophisticated users. Insurers are very concerned that less sophisticated users may misinterpret the resulting information. If a simple, transparent and conceptually acceptable way could have been found to eliminate the accounting mismatch at an acceptable cost without also obscuring the economic mismatch, that change might have been beneficial. However, the Board could find no such way in the short term. The Board also noted that any change could have required major systems changes and that there appeared to be no consensus among insurers on a single method.
 - (i) Extending the use of amortised cost would have created an inconsistency with US GAAP. The accounting mismatch described in paragraphs BC167 and BC172 has existed for some years in US GAAP, which requires insurers to account for their financial assets in broadly the same way as under IAS 39. Furthermore, the US Financial Accounting Standards Board decided in January 2004 not to add to its agenda a project to reconsider US GAAP for investments held by life insurance companies.
- BC174 In the light of these considerations, the Board concluded that changing the measurement requirements in IAS 39 for financial assets, even temporarily, would diminish the relevance and reliability of an insurer's financial statements. The Board observed that the accounting mismatch arose more from imperfections in existing measurement models for insurance liabilities than from deficiencies in the measurement of the assets. It would have been a retrograde step to try to mitigate the accounting mismatch by adopting a less relevant measurement of the assets—a measurement that would also have obscured some of the economic mismatch.
- BC175 The Board considered whether it could mitigate the accounting mismatch by permitting improvements to the measurement of insurance liabilities. The Board noted that introducing a current market-based discount rate for insurance liabilities rather than a historical discount rate would improve the relevance and reliability of an insurer's financial statements. Therefore, such a change would have been permitted by the proposals in ED 5 and is also permitted by the IFRS. However, IAS 8 requires consistent accounting policies for similar

transactions. For systems and other reasons, some insurers may not wish, or be able, in phase I to introduce a current market-based discount rate for all insurance liabilities.

BC176 The Board concluded that the increase in relevance and reliability from introducing a current discount rate could outweigh the disadvantages of permitting accounting policies that are not applied consistently to all similar liabilities. Accordingly, the Board decided to permit, but not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require. The Board noted that insurers might sometimes be able to develop simplified models that give a reasonable estimate of the effect of interest rate changes.

BC177 The Board also noted the following:

- (a) No single proposal would have eliminated the accounting mismatch for a broad cross-section of insurers without also obscuring the economic mismatch.
- (b) No single proposal would have been acceptable to a broad cross-section of insurers.
- (c) No single proposal could have been implemented by a broad cross-section of insurers without major systems changes. In other words, no solution was available that built on common industry approaches and systems. Furthermore, the systems needed to implement successfully the approach discussed with some European insurers (see paragraph BC173(g)) would also allow the approach permitted by paragraph 24 of the IFRS (adjusting designated liabilities for changes in interest rates). Indeed, paragraph 24 imposes fewer restrictions than the approach discussed with European insurers because it does not require the assets to match the liability cash flows closely, since any mismatch in cash flows is reflected in profit or loss.
- (d) Adjusting the discount rate for designated liabilities will not eliminate all the accounting mismatch described above and some, perhaps many, insurers will choose not to make that adjustment. The reasons for this are as follows:
 - (i) As noted above, many insurers may not have systems to adjust liabilities for changes in interest rates and may not wish to develop such systems, even for designated liabilities as opposed to all liabilities.
 - (ii) Changes in discount rates would not affect the measurement of insurance liabilities that are carried at an accumulated account value.
 - (iii) Changes in discount rates would not affect the measurement of financial liabilities with a demand feature, because IAS 39 states that their fair value is not less than the amount payable on demand (discounted, if applicable, from the first date when that

amount could be required to be paid). Although this last point is not strictly relevant for insurance contracts, many life insurers issue investment contracts for which it is relevant.

BC178 In summary, the Board decided not to amend existing measurement requirements in IAS 39 for financial assets because such amendments would have reduced the relevance and reliability of financial statements to an unacceptable extent. Although such amendments could have eliminated some of the accounting mismatch, they would also have obscured any economic mismatch that exists. The following points summarise amendments made to ED 5 that might mitigate the accounting mismatch in some cases, as well as relevant observations made by the Board:

- (a) The Board decided to permit, but not require, an insurer to change its accounting policies so that it remeasures designated insurance liabilities for changes in interest rates (see paragraph BC176).
- (b) The Board clarified the applicability of the practice sometimes known as 'shadow accounting' (paragraphs BC181–BC184).
- (c) The Board amended IAS 40 *Investment Property* to permit two separate elections when an entity selects the fair value model or the cost model for investment property. One election is for investment property backing contracts (which could be either insurance contracts or financial instruments) that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property. The other election is for all other investment property (see paragraph C12 of the IFRS).³⁵
- (d) The Board observed that some entities appeared to have misread the application guidance in IAS 39 on sales of held-to-maturity investments following a significant deterioration in the issuer's creditworthiness. Specifically, as noted in paragraph BC173(e), some appeared to have read it as limited to changes in a credit rating by an external credit rating agency, although the guidance also refers to internal ratings that meet particular criteria.
- (e) The Board observed that IAS 1 and IAS 32 do not preclude a presentation identifying a separate component of equity to report a portion of the change (and cumulative change) in the carrying amount of fixed-maturity available-for-sale financial assets. An insurer could use such a presentation to highlight the effect on equity of changes in interest rates that (i) changed the carrying amount of assets but (ii) did not change the carrying amount of liabilities that respond economically to those changing interest rates.

BC179 IAS 40 permits an entity to use a fair value model for investment property, but IAS 16 does not permit this model for owner-occupied property. An entity may measure its owner-occupied property at fair value using the revaluation model in IAS 16, but changes in its fair value must be recognised in revaluation surplus

³⁵ The amendments contained in paragraph C12 are now incorporated as paragraphs 32A–32C of IAS 40.

rather than in profit or loss. Some insurers regard their owner-occupied property as an investment and prefer to use a fair value model for it. However, the Board decided not to make piecemeal changes to IAS 16 and IAS 40 at this stage.

- BC180 The Board noted that shadow accounting (paragraphs BC181–BC184) may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an insurer elects to use shadow accounting, changes in the measurement of the liability resulting from revaluations of the property are recognised directly in equity, through the statement of changes in equity.

Shadow accounting

- BC181 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities.³⁶

- BC182 When many of those models were constructed, unrealised gains and most unrealised losses were not recognised in financial statements. Some of those models were extended later to require some financial assets to be measured at fair value, with changes in fair value recognised directly in equity (ie the same treatment as for available-for-sale financial assets under IAS 39). When this happened, a practice sometimes known as 'shadow accounting' was developed with the following two features:

- (a) A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.
- (b) If unrealised gains or losses on an asset are recognised directly in equity, the resulting change in the carrying amount of the insurance liability is also recognised in equity.

- BC183 Some respondents asked the Board to clarify whether the proposals in ED 5 permitted shadow accounting. The Board concluded the following:

- (a) In principle, gains and losses on an asset should not influence the measurement of an insurance liability (unless the gains or losses on the asset alter the amounts payable to policyholders). Nevertheless, this is a feature of some existing measurement models for insurance liabilities and the Board decided that it was not feasible to eliminate this practice in phase I (see paragraph BC134 for further discussion in the context of future investment margins).
- (b) Shadow accounting permits all recognised gains and losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (i) the gains and losses are realised or unrealised and (ii) unrealised gains and losses are recognised in profit or loss or directly in equity. This is a logical application of a feature of some existing models.

³⁶ Throughout this section, references to insurance liabilities are also relevant for (a) related deferred acquisition costs and (b) intangible assets relating to insurance contracts acquired in a business combination or portfolio transfer.

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- (c) Because the Board does not expect that feature of existing models to survive in phase II, insurers should not be required to develop systems to apply shadow accounting.
- (d) If an unrealised gain or loss on an asset triggers a shadow accounting adjustment to a liability, that adjustment should be recognised in the same way as the unrealised gain or loss.
- (e) In some cases and to some extent, shadow accounting might mitigate volatility caused by differences between the measurement basis for assets and the measurement basis for insurance liabilities. However, that is a by-product of shadow accounting and not its primary purpose.

BC184 Paragraph 30 of the IFRS permits, but does not require, shadow accounting. The Implementation Guidance includes an illustrative example to show how shadow accounting might become relevant in an environment where the accounting for assets changes so that unrealised gains are recognised (IG Example 4). Because the Board does not expect the feature underlying the use of shadow accounting to survive in phase II, the Board decided not to give further guidance.

Investment contracts

BC185 Many insurers issue investment contracts (ie financial instruments that do not transfer enough insurance risk to qualify as insurance contracts). Under IAS 39, the issuer measures investment contracts at either amortised cost or, with appropriate designation at inception, at fair value. Some aspects of the measurements under IAS 39 differ from the measurements that are often used at present under national accounting requirements for these contracts:

- (a) The definition and treatment of transaction costs under IAS 39 may differ from the definition and treatment of acquisition costs in some national requirements.
- (b) The condition in IAS 39 for treating a modification of a financial liability (or the exchange of the new liability for an old liability) as an extinguishment of the original liability may differ from equivalent national requirements.
- (c) Future cash flows from assets do not affect the amortised cost or fair value of investment contract liabilities (unless the cash flows from the liabilities are contractually linked to the cash flows from the assets).
- (d) The amortised cost of a financial liability is not adjusted when market interest rates change, even if the return on available assets is below the effective interest rate on the liability (unless the change in rates causes the liability cash flows to change).
- (e) The fair value of a financial liability with a demand feature is not less than the amount payable on demand.

- (f) The fair value of a financial instrument reflects its credit characteristics.³⁷
 - (g) Premiums received for an investment contract are not recognised as revenue under IAS 39, but as balance sheet movements, in the same way as a deposit received.
- BC186 Some argued that the Board should not require insurers to change their accounting for investment contracts in phase I because the scope of phase I is intended to be limited and because the current treatment of such contracts is often very similar to the treatment of insurance contracts. However, the Board saw no reason to delay the application of IAS 39 to contracts that do not transfer significant insurance risk. The Board noted that some of these contracts have features, such as long maturities, recurring premiums and high initial transaction costs, that are less common in other financial instruments. Nevertheless, applying a single set of accounting requirements to all financial instruments will make an insurer's financial statements more relevant and reliable.
- BC187 Some contracts within the scope of IAS 39 grant cancellation or renewal rights to the holder. The cancellation or renewal rights are embedded derivatives and IAS 39 requires the issuer to measure them separately at fair value if they are not closely related to their host contract (unless the issuer elects to measure the entire contract at fair value).

Embedded derivatives

- BC188 Some suggested that the Board should exempt insurers from the requirement to separate embedded derivatives contained in a host insurance contract and measure them at fair value under IAS 39. They argued that:
- (a) separating these derivatives would require extensive and costly systems changes that might not be needed for phase II.
 - (b) some of these derivatives are intertwined with the host insurance contract in a way that would make separate measurement arbitrary and perhaps misleading, because the fair value of the whole contract might differ from the sum of the fair values of its components.
- BC189 Some suggested that the inclusion of embedded options and guarantees in the cash flows used for a liability adequacy test could permit the Board to exempt some embedded derivatives from fair value measurement under IAS 39. Most proponents of this exemption implied that including only the intrinsic value of these items (ie without their time value) would suffice. However, because excluding the time value of these items could make an entity's financial statements much less relevant and reliable, the Board did not create such an exemption.
- BC190 In the Board's view, fair value is the only relevant measurement basis for derivatives, because it is the only method that provides sufficient transparency in the financial statements. The cost of most derivatives is nil or immaterial.

³⁷ IFRS 13, issued in May 2011, states that the fair value of a liability reflects the effect of non-performance risk, which includes, but may not be limited to, an entity's own credit risk.

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Hence if derivatives were measured at cost, they would not be included in the balance sheet and their success (or otherwise) in reducing risk, or their role in increasing risk, would not be visible. In addition, the value of derivatives often changes disproportionately in response to market movements (put another way, they are highly leveraged or carry a high level of risk). Fair value is the only measurement basis that can capture this leveraged nature of derivatives—information that is essential to communicate to users the nature of the rights and obligations inherent in derivatives.

- BC191 IAS 39 requires entities to account separately for derivatives embedded in non-derivative contracts. This is necessary:
- (a) to ensure that contractual rights and obligations that create similar risk exposures are treated in the same way whether or not they are embedded in a non-derivative contract.
 - (b) to counter the possibility that entities might seek to avoid the requirement to measure derivatives at fair value by embedding a derivative in a non-derivative contract.
- BC192 The requirement to separate embedded derivatives already applied to a host contract of any kind before the IFRS was issued. Exempting insurance contracts from that existing requirement would have been a retrograde step. Furthermore, much of the effort needed to measure embedded derivatives at fair value arises from the need to identify the derivatives and from other steps that will still be needed if the Board requires fair value measurement for phase II. In the Board's view, the incremental effort needed to identify the embedded derivatives separately in phase I is relatively small and is justified by the increased transparency that fair value measurement brings. IG Example 2 in the Implementation Guidance gives guidance on the treatment of various forms of embedded derivative.
- BC193 Some embedded derivatives meet the definition of an insurance contract. It would be contradictory to require a fair value measurement in phase I of an insurance contract that is embedded in a larger contract when such measurement is not required for a stand-alone insurance contract. Therefore, the IFRS confirms that this is not required (paragraph 8). For the same reason, the Board concluded that an embedded derivative is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (see new paragraph AG33(h) of IAS 39). Without this conclusion, paragraph 12 of IAS 39 would have required the insurer to measure the entire contract at fair value. An alternative approach would have been to retain that requirement, but require measurement at cost if an insurance contract cannot be measured reliably at fair value in its entirety, building on a similar treatment in IAS 39 for unquoted equity instruments. However, the Board did not intend to require fair value measurement for insurance contracts in phase I. Therefore, the Board decided not to require this even when it is possible to measure reliably the fair value of an insurance contract containing an embedded derivative.
- BC194 The Board acknowledges that insurers need not, during phase I, recognise some potentially large exposures to items such as guaranteed annuity options and

guaranteed minimum death benefits. These items create risks that many regard as predominantly financial, but if the payout is contingent on an event that creates significant insurance risk, these embedded derivatives meet the definition of an insurance contract. The IFRS requires specific disclosures about these items (paragraph 39(e)). In addition, the liability adequacy test requires an entity to consider them (see paragraphs BC94–BC104).

Elimination of internal items

- BC195 Some respondents suggested that financial instruments issued by one entity to a life insurer in the same group should not be eliminated from the group's consolidated financial statements if the life insurer's assets are earmarked as security for policyholders' savings.
- BC196 The Board noted that these financial instruments are not assets and liabilities from the group's perspective. The Board saw no justification for departing from the general principle that all intragroup transactions are eliminated, even if they are between components of an entity that have different stakeholders, for example policyholder funds and shareholder funds. However, although the transactions are eliminated, they may affect future cash flows. Hence, they may be relevant in measuring liabilities.
- BC197 Some respondents argued that non-elimination would be consistent with the fact that financial instruments issued can (unless they are non-transferable) be plan assets in defined benefit plans under IAS 19 *Employee Benefits*. However, the Board did not view IAS 19 as a precedent in this area. IAS 19 requires a presentation net of plan assets because investment in plan assets reduces the obligation (IAS 19 Basis for Conclusions paragraph BC66). This presentation does not result in the recognition of new assets and liabilities.

Income taxes

- BC198 Some respondents argued that discounting should be required, or at least permitted, for deferred tax relating to insurance contracts. The Board noted that discounting of a temporary difference is not relevant if an item's tax base and carrying amount are both determined on a present value basis.

Disclosure

- BC199 The disclosure requirements are designed as a pair of high level principles, supplemented by some specified disclosures to meet those objectives. Implementation Guidance, published in a separate booklet,³⁸ discusses how an insurer might satisfy the requirements.
- BC200 Although they agreed that insurers should be allowed flexibility in determining the levels of aggregation and amount of disclosure, some respondents suggested that the Board should introduce more specific and standardised disclosure requirements. Others suggested that the draft Implementation Guidance published with ED 5 was at too high a level to ensure consistency and

³⁸ but included in this volume.

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comparability and that its non-mandatory nature might diminish its usefulness. Some were concerned that different levels of aggregation by different insurers could reduce comparability.

- BC201 Nevertheless, the Board retained ED 5's approach. The Board viewed this as superior to requiring a long list of detailed and descriptive disclosures, because concentrating on the underlying principles:
- (a) makes it easier for insurers to understand the rationale for the requirements, which promotes compliance.
 - (b) avoids 'hard-wiring' into the IFRS disclosures that may become obsolete, and encourages experimentation that will lead to improvements as techniques develop.
 - (c) avoids requiring specific disclosures that may not be needed to meet the underlying objectives in the circumstances of every insurer and could lead to information overload that obscures important information in a mass of detail.
 - (d) gives insurers flexibility to decide on an appropriate level of aggregation that enables users to see the overall picture but without combining information that has different characteristics.
- BC202 Some respondents expressed the following general concerns about the proposed disclosure requirements in ED 5:
- (a) The proposed volume of disclosure was excessive and some of it would duplicate extensive material included in some countries in prudential returns.
 - (b) Some of the proposed disclosures would be difficult and costly to prepare and audit, make it difficult to prepare timely financial statements and provide users with little value.
 - (c) The proposals in ED 5 would require excessive disclosure of sensitive pricing information and other confidential proprietary information.
 - (d) Some of the disclosures exceeded those required in other industries, which singled out insurers unfairly. Some felt that the level of disclosure would be particularly burdensome for small insurers, whereas others referred to the difficulty of aggregating information in a meaningful way for large international groups.
- BC203 The two principles and most of the supporting requirements are applications of existing requirements in IFRSs, or relatively straightforward analogies with existing IFRS requirements (particularly IFRS 7 *Financial Instruments: Disclosures*).
- BC203A IFRS 7 was issued in August 2005 and replaced the disclosure requirements in IAS 32, including those on which the disclosures originally in IFRS 4 were based. Accordingly, the Board amended the disclosure requirements in IFRS 4 to be consistent with IFRS 7, when possible. The Board noted that:
- (a) insurers will have both insurance contracts and financial instruments. In particular, some of the investment products issued by insurers are financial instruments, not insurance contracts as defined in IFRS 4. It is

more useful for users and easier for preparers if the risk disclosures for insurance contracts and financial instruments are the same.

- (b) making the disclosure requirements of IFRS 4 consistent with IFRS 7 makes the disclosures easier to prepare. In particular, IFRS 7 removes the 'terms and conditions' disclosure previously in paragraph 39(b) of IFRS 4. Some commentators on ED 5 (the Exposure Draft that preceded IFRS 4) objected to this disclosure requirement, believing it to be onerous and not to provide the most useful information.
- (c) the disclosures in IFRS 7 are designed to be implemented as a package, and if implemented piecemeal would result in less useful information for users. For example, the risk disclosures replace the 'terms and conditions' disclosure previously in paragraph 60(a) of IAS 32 and paragraph 39(b) of IFRS 4. Merely updating the reference in paragraph 39(d) from IAS 32 to IFRS 7 would have resulted in some, but not all, of the risk disclosures being applicable to insurance contracts and the 'terms and conditions' disclosure being retained.
- (d) as discussed in paragraph BC207, significant changes to the risk disclosures in paragraphs 38–39A are not expected as a result of phase II of the project on insurance contracts (although consequential changes may be needed to the accounting-related disclosures in paragraphs 36 and 37).

BC203B Some respondents, particularly preparers, did not agree that IFRS 4 should be amended as part of IFRS 7. In particular, some respondents argued that sensitivity analysis of market risk would be problematic for insurance contracts; they disagreed that such an analysis would be relatively easy to understand or calculate while issues relating to the measurement of fair value for insurance contracts remain unresolved. Those respondents suggested that disclosure requirements on sensitivity analysis should be considered during phase II of the project on insurance contracts, rather than in finalising IFRS 7. The Board noted that this requirement should not be unduly onerous for insurers, nor require them to provide quantitative information, because the sensitivity analysis applies only to changes in market risk variables that have an effect on profit or loss and equity in the period being reported. In addition, the Board noted that a sensitivity analysis is intended to replace the terms and conditions disclosures, which entities found onerous. The Board did not want to *require* insurers to comply with the older terms and conditions disclosures while allowing other entities to use the less onerous sensitivity analysis. However, the Board also noted that providing the sensitivity analysis would mean systems changes for some entities. Because the purpose of IFRS 4 was to minimise such changes pending the outcome of phase II, the Board did not want to require extensive systems changes for insurance contracts as a result of IFRS 7.

BC203C To address the concerns of those who do not want to make systems changes and those who want to substitute the new sensitivity analysis for the terms and conditions disclosures, the Board decided to permit a choice of sensitivity analysis disclosures for insurance risk only. Paragraph 39A of IFRS 4 has been added so that entities will be able to choose between providing:

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- (a) the terms and conditions disclosures, together with the qualitative sensitivity analysis currently permitted by IFRS 4; or
- (b) the quantitative sensitivity analysis required by IFRS 7 (and permitted, but not required, by IFRS 4).

The Board permitted entities to choose to disclose a combination of qualitative and quantitative sensitivity analysis for insurance risk because it believes that entities should not be prevented from providing more useful information for some insurance risks, even if they do not have the ability to provide this information for all insurance risks. The Board noted that this option was a temporary solution to the problems cited in paragraph BC203B and would be eliminated in phase II.

BC204 Many respondents asked the Board to clarify the status of the Implementation Guidance. In particular, some felt that the Implementation Guidance appeared to impose detailed and voluminous requirements that contradicted the Board's stated intention in paragraph BC201. In response to requests from respondents, the Board added paragraph IG12 to clarify the status of the implementation guidance on disclosure.

BC205 Some suggested that some of the disclosures, particularly those that are qualitative rather than quantitative or convey management's assertions about possible future developments, should be located outside the financial statements in a financial review by management. However, in the Board's view, the disclosure requirements are all essential and should be part of the financial statements.

BC206 Some argued that the disclosure requirements could be particularly onerous and less relevant for a subsidiary, especially if the parent guarantees the liabilities or the parent reinsures all the liabilities. However, the Board decided that no exemptions from the disclosure principles were justified. Nevertheless, the high level and flexible approach adopted by the Board enables a subsidiary to disclose the required information in a way that suits its circumstances.

BC207 Some respondents expressed concerns that the disclosure proposals in ED 5 might require extensive systems changes in phase I that might not be needed in phase II. The Board expects that both disclosure principles will remain largely unchanged for phase II, although the guidance to support them may need refinement because different information will be available and because insurers will have experience of developing systems to meet the disclosure principles in phase I.

Materiality

BC208 Some respondents expressed concerns that the IFRS (reinforced by the Implementation Guidance) might require disclosure of excessively detailed information that might not be beneficial to users. In response to these concerns, the Board included in the Implementation Guidance a discussion of materiality taken from IAS 1.

BC209 Some respondents suggested that some of the qualitative disclosures should not be subject to the normal materiality threshold, which might, in their view, lead to excessive disclosure. They proposed using different terminology, such as

'significant', to reinforce that message. However, the Board noted that not requiring disclosure of material information would be inconsistent with the definition of materiality. Thus, the Board concluded that the disclosure should, in general, rely solely on the normal definition of materiality.

- BC210 In one place, the IFRS refers to a different notion. Paragraph 37(c) refers to the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts. Because many assumptions could be relevant, the Board decided to narrow the scope of the disclosure somewhat.

Explanation of recognised amounts

Assumptions

- BC211 The first disclosure principle in the IFRS requires disclosure of amounts in an insurer's balance sheet³⁹ and income statement⁴⁰ that arise from insurance contracts (paragraph 36 of the IFRS). In support of this principle, paragraph 37(c) and (d) requires disclosure about assumptions and changes in assumptions. The disclosure of assumptions both assists users in testing reported information for sensitivity to changes in those assumptions and enhances their confidence in the transparency and comparability of the information.
- BC212 Some expressed concerns that information about assumptions and changes in assumptions might be costly to prepare and of limited usefulness. There are many possible assumptions that could be disclosed: excessive aggregation would result in meaningless information, whereas excessive disaggregation could be costly, lead to information overload, and reveal commercially sensitive information. In response to these concerns, the disclosure about the assumptions focuses on the process used to derive them.
- BC213 Some respondents argued that it is difficult to disclose meaningful information about changes in interdependent assumptions. As a result, an analysis by sources of change often depends on the order in which the analysis is performed. To acknowledge this difficulty, the IFRS does not specify a rigid format or contents for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for the risks they face and the systems that they have, or can enhance at a reasonable cost.

Changes in insurance liabilities

- BC214 Paragraph 37(e) of the IFRS requires a reconciliation of changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs. IAS 37 requires broadly comparable disclosure of changes in provisions, but the scope of IAS 37 excludes insurance contracts. Disclosure about changes in deferred acquisition costs is important because some existing methods use adjustments

³⁹ IAS 1 *Presentation of Financial Statements* (as revised in 2007) replaced the term 'balance sheet' with 'statement of financial position'.

⁴⁰ IAS 1 (revised 2007) requires an entity to present all income and expense items in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

to deferred acquisition costs as a means of recognising some effects of remeasuring the future cash flows from an insurance contract (for example, to reflect the result of a liability adequacy test).

Nature and extent of risks arising from insurance contracts

BC215 The second disclosure principle in the IFRS requires disclosure of information that enables users to understand the nature and extent of risks arising from insurance contracts (paragraph 38 of the IFRS). The Implementation Guidance supporting this principle builds largely on existing requirements in IFRSs, particularly the disclosures for financial instruments in IFRS 7.

BC216 Some respondents read the draft Implementation Guidance accompanying ED 5 as implying that the IFRS would require disclosures of estimated cash flows. That was not the Board's intention because insurers cannot be expected to have systems to prepare detailed estimates of cash flows in phase I (beyond what is needed for the liability adequacy test). The Board revised the Implementation Guidance to emphasise that the second disclosure principle requires disclosure **about** cash flows (ie disclosure that helps users understand their amount, timing and uncertainty), not disclosure **of** cash flows.⁴¹

Insurance risk

BC217 For insurance risk (paragraph 39(c)), the disclosures are intended to be consistent with the spirit of the disclosures required by IAS 32.⁴² The usefulness of particular disclosures about insurance risk depends on the circumstances of a particular insurer. Therefore, the requirements are written in general terms to allow practice in this area to evolve.

Sensitivity analysis

BC218 Paragraph 39(c)(i) requires disclosure of a sensitivity analysis. The Board decided not to include specific requirements that may not be appropriate in every case and could impede the development of more useful forms of disclosure or become obsolete.

BC219 IAS 32⁴² requires disclosure of a sensitivity analysis only for assumptions that are not supported by observable market prices or rates. However, because the IFRS does not require a specific method of accounting for embedded options and guarantees, including some that are partly dependent on observable market prices or rates, paragraph 39(c)(i) requires a sensitivity analysis for all variables that have a material effect, including variables that are observable market prices or rates.

Claims development

BC220 Paragraph 39(c)(iii) requires disclosure about claims development. The US Securities and Exchange Commission requires property and casualty

⁴¹ IFRS 7 replaced the required disclosures about cash flows with required disclosures about the nature and extent of risks.

⁴² In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

insurers to provide a table showing the development of provisions for unpaid claims and claim adjustment expenses for the previous ten years, if the provisions exceed 50 per cent of equity. The Board noted that the period of ten years is arbitrary and decided instead to set the period covered by this disclosure by reference to the length of the claims settlement cycle. Therefore, the IFRS requires that the disclosure should go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years (subject to transitional exemptions in paragraph 44 of the IFRS). Furthermore, the proposal applies to all insurers, not only to property and casualty insurers. However, because an insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year, it is unlikely that many life insurers would need to give this disclosure.

- BC221 In the US, disclosure of claims development is generally presented in management's discussion and analysis, rather than in the financial statements. However, this disclosure is important because it gives users insights into the uncertainty surrounding estimates about future claims, and also indicates whether a particular insurer has tended to overestimate or underestimate ultimate payments. Therefore, the IFRS requires it in the financial statements.

Probable maximum loss

- BC222 Some suggested that an insurer—particularly a general insurer—should disclose the probable maximum loss (PML) that it would expect if a reasonably extreme event occurred. For example, an insurer might disclose the loss that it would suffer from a severe earthquake of the kind that would be expected to recur every one hundred years, on average. However, given the lack of a widely agreed definition of PML, the Board concluded that it is not feasible to require disclosure of PML or similar measures.

Exposures to interest rate risk or market risk

- BC223 As discussed in paragraphs BC193 and BC194, the Board confirmed that an insurer need not account at fair value for embedded derivatives that meet the definition of an insurance contract, but also create material exposures to interest rate risk or market risk. For many insurers, these exposures can be large. Therefore, paragraph 39(e) of the IFRS specifically requires disclosures about these exposures.

Fair value of insurance liabilities and insurance assets

- BC224 ED 5 proposed that an insurer should disclose the fair value of its insurance liabilities and insurance assets. This proposal was intended (a) to give useful information to users of an insurer's financial statements and (b) to encourage insurers to begin work on systems that use updated information, to minimise the transition period for phase II.
- BC225 Some respondents supported the proposed disclosure of fair value, arguing that it is important information for users. Some felt that this would be particularly important given the range of measurement practices in phase I. However, many respondents (including some who supported a fair value disclosure requirement

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in principle) suggested that the Board should delete this requirement or suspend it until phase II is completed. They offered the following arguments:

- (a) Requiring such disclosure would be premature before the Board resolves significant issues about fair value measurement and gives adequate guidance on how to determine fair value.⁴³ The lack of guidance would lead to lack of comparability for users, place unreasonable demands on preparers and pose problems of auditability. Furthermore, disclosure cannot rectify that lack of comparability because it is difficult to describe the features of different models clearly and concisely.
- (b) Disclosure by 2006 (as proposed in ED 5) would be impracticable because insurers would not have time to create and test the necessary systems.
- (c) Expecting insurers to begin work on an unknown objective would be costly and waste time. Furthermore, in the absence of agreed methods for developing fair value, the systems developed for phase I disclosures of fair value might need changes for phase II.
- (d) The proposal asked for a mandate for the IASB to interpret its own requirement before explaining what it means.

BC226 The Board did not view the proposed requirement to disclose fair value as conditional on the measurement model for phase II. In the Board's view, disclosure of the fair value of insurance liabilities and insurance assets would provide relevant and reliable information for users even if phase II does not result in a fair value model. However, the Board agreed with respondents that requiring disclosure of fair value would not be appropriate at this stage.

Summary of changes from ED 5

BC227 The following is a summary of the main changes from ED 5 to the IFRS. The Board:

- (a) clarified aspects of the definition of an insurance contract (paragraphs BC36 and BC37).
- (b) clarified the requirement to unbundle deposit components in some (limited) circumstances (paragraphs BC40–BC54).
- (c) deleted the 'sunset clause' proposed in ED 5 (paragraphs BC84 and BC85).
- (d) clarified the need to consider embedded options and guarantees in a liability adequacy test (paragraph BC99) and clarified the level of aggregation for the liability adequacy test (paragraph BC100).
- (e) replaced the impairment test for reinsurance assets. Instead of referring to IAS 36 (which contained no scope exclusion for reinsurance assets before the Board issued IFRS 4), the test will refer to IAS 39 (paragraphs BC107 and BC108).

⁴³ IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

- (f) deleted the proposed ban on recognising a gain at inception of a reinsurance contract, and replaced this with a disclosure requirement (paragraphs BC109–BC114).
- (g) clarified the treatment of acquisition costs for contracts that involve the provision of investment management services (paragraphs BC118 and BC119).
- (h) changed the prohibition on introducing asset-based discount rates into a rebuttable presumption (paragraphs BC134–BC144).
- (i) clarified aspects of the treatment of discretionary participation features (paragraphs BC154–BC165) and created an explicit new exemption from the requirement to separate, and measure at fair value, some options to surrender a contract with a discretionary participation feature (paragraph 9 of the IFRS).
- (j) introduced an option for an insurer to change its accounting policies so that it remeasures designated insurance liabilities in each period for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require (paragraphs BC174–BC177).
- (k) amended IAS 40 to permit two separate elections for investment property when an entity selects the fair value model or the cost model. One election is for investment property backing contracts that pay a return linked directly to the fair value of, or returns from, that investment property. The other election is for all other investment property (paragraph BC178).
- (l) clarified the applicability of shadow accounting (paragraphs BC181–BC184).
- (m) clarified that an embedded derivative is closely related to the host insurance contract if they are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract) (paragraph BC193).
- (n) clarified that the Implementation Guidance does not impose new disclosure requirements (paragraph BC204).
- (o) deleted the proposed requirement to disclose the fair value of insurance contracts from 2006 (paragraphs BC224–BC226).
- (p) provided an exemption from applying most disclosure requirements for insurance contracts to comparatives that relate to 2004 (paragraphs 42–44 of the IFRS).
- (q) confirmed that unit-denominated payments can be measured at current unit values, for both insurance contracts and investment contracts, avoiding the apparent need to separate an ‘embedded derivative’ (paragraph AG33(g) of IAS 39, inserted by the IFRS).

Dissenting opinions on IFRS 4

- DO1 Professor Barth and Messrs Garnett, G  lard, Leisenring, Smith and Yamada dissent from the issue of IFRS 4.

Dissent of Mary E Barth, Robert P Garnett, Gilbert G  lard, James J Leisenring and John T Smith

- DO2 Messrs Garnett and G  lard dissent for the reasons given in paragraphs DO3 and DO4 and Mr Garnett also dissents for the reasons given in paragraphs DO5 and DO6. Professor Barth and Messrs Leisenring and Smith dissent for the reasons given in paragraphs DO3–DO8 and Mr Smith also dissents for the reasons given in paragraphs DO9–DO13.

Temporary exemption from paragraphs 10–12 of IAS 8

- DO3 Professor Barth and Messrs Garnett, G  lard, Leisenring and Smith dissent because IFRS 4 exempts an entity from applying paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when accounting for insurance and reinsurance contracts. They believe that all entities should be required to apply these paragraphs. These Board members believe that the requirements in IAS 8 have particular relevance and applicability when an IFRS lacks specificities, as does IFRS 4, which allows the continuation of a variety of measurement bases for insurance and reinsurance contracts. Because of the failure to consider the IASB *Framework*,⁴⁴ continuation of such practices may result in the inappropriate recognition of, or inappropriate failure to recognise, assets, liabilities, equity, income and expense. In these Board members' view, if an entity cannot meet the basic requirements of paragraphs 10–12 of IAS 8, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.
- DO4 These Board members' concerns are heightened by the delay in completing phase II of the Board's project on accounting for insurance contracts. Although phase II is on the Board's active agenda, it is unlikely that the Board will be able to develop an IFRS on insurance contracts in the near term. Accordingly, it is likely that the exemption from IAS 8 will be in place for some time.

Future investment margins and shadow accounting

- DO5 Professor Barth and Messrs Garnett, Leisenring and Smith dissent for the further reason that they would not permit entities to change their accounting policies for insurance and reinsurance contracts to policies that include using future investment margins in the measurement of insurance liabilities. They agree with the view expressed in paragraph BC134 that cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect the cash flows arising from the liability or the credit characteristics of the liability). Therefore, they believe that changing to an accounting policy for insurance contracts that uses future investment margins to measure liabilities arising

⁴⁴ References to the *Framework* are to IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

from insurance contracts reduces the relevance and reliability of an insurer's financial statements. They do not believe that other aspects of an accounting model for insurance contracts can outweigh this reduction.

- DO6 These four Board members also would not permit entities to change their accounting policies for insurance and reinsurance contracts to policies that include using what is called shadow accounting. They do not believe that the changes in the carrying amount of insurance liabilities (including related deferred acquisition costs and intangible assets) under shadow accounting should be recognised directly in equity. That these changes in the measurement of the liability are calculated on the basis of changes in the measurement of assets is irrelevant. These Board members believe that these changes in insurance liabilities result in expenses that under the IASB *Framework* should be recognised in profit or loss.

Financial instruments with a discretionary participation feature⁴⁵

- DO7 Professor Barth and Messrs Leisenring and Smith would not permit entities to account for a financial instrument with a discretionary participation feature on a basis that differs from that required by IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. Those Standards require entities to separate the components of a compound financial instrument, recognise the liability component initially at fair value, and attribute any residual to the equity component. These three Board members believe that the difficulty in determining whether a discretionary participation feature is a liability or equity does not preclude applying the measurement requirements in IAS 39 to the liability and equity components once the entity makes that determination. These three Board members believe that an entity would misstate interest expense if the financial liability component is not initially measured at its fair value.
- DO8 These three Board members would require entities to ensure in all cases that the liability recognised for financial instruments with a discretionary participation feature is no less than the amount that would result from applying IAS 39 to the guaranteed element. Paragraph 35 of IFRS 4 requires this if an entity classifies none or some of the feature as a liability, but not if it classifies all of the feature as a liability.

Financial instruments⁴⁶

- DO9 Mr Smith also dissents from IFRS 4 because he believes it defines insurance contracts too broadly and makes unnecessary exceptions to the scope of IAS 32 and IAS 39. In his view, this permits the structuring of contractual provisions to avoid the requirements of those Standards, diminishing their effectiveness and adding considerable complexity in interpreting and applying them and IFRS 4. He believes that many of the exceptions, based on the desire to avoid systems changes, are unnecessary because they generally are unrelated to the second

⁴⁵ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

⁴⁶ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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phase of the project on insurance contracts, and they create a disincentive to enhance systems before the second phase of that project is completed. Mr Smith believes that IAS 32 and IAS 39 already contain the appropriate solutions when measurements cannot be made reliably and those solutions make systems limitations transparent.

- DO10 Paragraph 10 of IFRS 4 requires an insurer to unbundle a deposit component of an insurance contract if the insurer can measure the deposit component separately and the insurer's accounting policies do not otherwise require it to recognise all rights and obligations arising from the deposit component. Mr Smith notes that the deposit component consists entirely of financial liabilities or financial assets. Therefore, he believes that the deposit component of all insurance contracts should be unbundled. Mr Smith notes that IAS 32 already requires the liability component of a compound financial instrument to be separated at its fair value with any residual accounted for as equity. He believes this approach could be applied by analogy when an insurance contract contains a financial liability and would represent a superior solution.
- DO11 IFRS 4 amends IAS 39 by stating that an embedded derivative and the host insurance contract are closely related if they are so interdependent that the entity cannot measure the embedded derivative separately. This creates an exemption from the requirement in IAS 39 to account for such embedded derivatives at fair value. Mr Smith disagrees with that change. In particular, if a contract permits a policyholder to obtain a derivative-based cash settlement in lieu of maintaining insurance, Mr Smith believes that the derivative-based cash settlement alternative is a financial liability and should be measured at fair value.
- DO12 For the contracts discussed in the previous paragraph, Mr Smith believes that IAS 39 already provides a superior solution that will not promote structuring to take advantage of an exception to IAS 39. It requires the entire contract to be measured at fair value when an embedded derivative cannot be reliably separated from the host contract. However, Mr Smith would amend IAS 39 to require measurement at cost if a contract cannot be measured reliably at fair value in its entirety and contains a significant insurance component as well as an embedded derivative. This amendment would be consistent with similar requirements in IAS 39 for unquoted equity instruments. To make systems limitations more transparent, Mr Smith would add the disclosure required by IAS 32, including the fact that fair value cannot be measured reliably, a description of the insurance contracts in question, their carrying amounts, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is likely to fall.
- DO13 Mr Smith would exclude from the definition of an insurance contract those contracts that are regarded as transferring significant insurance risk at inception only because they include a pricing option permitting the holder to purchase insurance at a specified price at a later date. He would also exclude from the definition those contracts in which the insurance component has expired. He believes that any remaining obligation is a financial instrument that should be accounted for under IAS 39.

Dissent of Tatsumi Yamada

- DO14 Mr Yamada dissents from the issue of IFRS 4 because he believes that it does not resolve appropriately the mismatch in measurement base between financial assets of insurers and their insurance liabilities. Specifically:
- (a) he disagrees with the inclusion of an option to introduce a current discount rate for designated insurance liabilities.
 - (b) he believes that the Board should have provided a practicable means to reduce the effect of the accounting mismatch using methods based partly on some existing practices that involve broader, but constrained, use of amortised cost.

Option to introduce a current discount rate

- DO15 Mr Yamada disagrees with paragraph 24 of the IFRS, which creates an option to introduce a current market-based discount rate for designated insurance liabilities. He has sympathy for the view expressed in paragraph BC175 that introducing a current market-based discount rate for insurance liabilities rather than a historical discount rate would improve the relevance and reliability of an insurer's financial statements. However, as explained in paragraph BC126, 'the Board will not address discount rates and the basis for risk adjustments until phase II.' Therefore, Mr Yamada believes that it is not appropriate to deal with measurement of insurance liabilities in phase I of this project.
- DO16 In addition, Mr Yamada believes that there should be a stringent test to assess whether changes in the carrying amount of the designated insurance liabilities mitigate the changes in carrying amount of financial assets. Without such a test, management will have a free choice to decide the extent to which it introduces remeasurement of insurance liabilities. Therefore, he does not agree with the Board's conclusion in paragraph BC176 that 'the increase in relevance and reliability from introducing a current discount rate could outweigh the disadvantages of permitting accounting policies that are not applied consistently to all similar liabilities'.
- DO17 Furthermore, the option introduced by paragraph 24 is not an effective way to reduce the accounting mismatch, in Mr Yamada's view. He agrees with the Board's analysis that 'many insurers may not have systems to adjust liabilities for changes in interest rates and may not wish to develop such systems, even for designated liabilities as opposed to all liabilities', as explained in paragraph BC177(d)(i).

Assets held to back insurance liabilities⁴⁷

- DO18 As stated in paragraph BC171, many of the respondents to ED 5 urged the Board to explore ways of reducing the accounting mismatch. Mr Yamada notes that IFRS 4 provides some limited solutions for the accounting mismatch by clarifying that shadow accounting can be used and amending IAS 40 to permit two separate elections when an entity selects the fair value model or the cost model for investment property. IFRS 4 also provides an option to introduce a

⁴⁷ In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

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current market-based discount rate for designated insurance liabilities but, for reasons given in paragraphs DO15–DO17, Mr Yamada does not support that option.

DO19 Mr Yamada believes that it would have been appropriate to provide a more broadly applicable way of mitigating the effect of the accounting mismatch. Because phase I is only a stepping stone to phase II, Mr Yamada is of the view that the only practicable solution in the short term is one based on the existing practices of insurers. He believes that if remeasurement of insurance liabilities by a current market-based discount rate is allowed as means of resolving the mismatch, a new category of assets carried at amortised cost such as the Japanese 'debt securities earmarked for policy reserve' (DSR) should also have been allowed in phase I.

DO20 Although Mr Yamada acknowledges that the DSR approach would not lead to more relevant and reliable measurements, he notes that insurers have several years' experience of using this approach, which was created in 2000 when Japan introduced an accounting standard for financial instruments that is similar to IASs 32 and 39. He believes that no perfect solution is available in phase I and together with the disclosure of fair value information required by IAS 32, the DSR approach would provide a reasonable solution for phase I. Therefore he does not agree with the Board's conclusion in paragraph BC178 that amending the existing measurement requirements in IAS 39 for financial assets 'would have reduced the relevance and reliability of financial statements to an unacceptable extent'. Indeed, Mr Yamada believes the exemption in IFRS 4 from paragraphs 10–12 of IAS 8 could impair the relevance and reliability of financial statements more than introducing the DSR approach would have done.

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IFRS 4 *INSURANCE CONTRACTS***

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**Guidance on implementing
IFRS 4 *Insurance Contracts***

This guidance accompanies, but is not part of, IFRS 4.

Introduction

- IG1 This implementation guidance:
- (a) illustrates which contracts and embedded derivatives are within the scope of the IFRS (see paragraphs IG2–IG4).
 - (b) includes an example of an insurance contract containing a deposit component that needs to be unbundled (paragraph IG5).
 - (c) illustrates shadow accounting (paragraphs IG6–IG10).
 - (d) discusses how an insurer might satisfy the disclosure requirements in the IFRS (paragraphs IG11–IG71).

Definition of insurance contract

- IG2 IG Example 1 illustrates the application of the definition of an insurance contract. The example does not illustrate all possible circumstances.

IG Example 1: Application of the definition of an insurance contract		
<i>Contract type</i>		<i>Treatment phase I</i>
1.1	Insurance contract (see definition in Appendix A of the IFRS and guidance in Appendix B).	Within the scope of the IFRS, unless covered by scope exclusions in paragraph 4 of the IFRS. Some embedded derivatives and deposit components must be separated (see IG Examples 2 and 3 and paragraphs 7–12 of the IFRS).
1.2	Death benefit that could exceed amounts payable on surrender or maturity.	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the policyholder dies early. See IG Examples 1.23–27 for further discussion of surrender penalties.

continued...

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IG Example 1: Application of the definition of an insurance contract		
1.3	A unit-linked contract that pays benefits linked to the fair value of a pool of assets. The benefit is 100 per cent of the unit value on surrender or maturity and 101 per cent of the unit value on death.	This contract contains a deposit component (100 per cent of unit value) and an insurance component (additional death benefit of 1 per cent). Paragraph 10 of the IFRS permits unbundling (but requires it only if the insurance component is material and the issuer would not otherwise recognise all obligations and rights arising under the deposit component). If the insurance component is not unbundled, the whole contract is an investment contract because the insurance component is insignificant in relation to the whole contract.
1.4	Life-contingent annuity.	Insurance contract (unless contingent amount is insignificant in all scenarios that have commercial substance). Insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.
1.5	Pure endowment. The insured person receives a payment on survival to a specified date, but beneficiaries receive nothing if the insured person dies before then.	Insurance contract (unless the transfer of insurance risk is insignificant). If a relatively homogeneous book of pure endowments is known to consist of contracts that all transfer insurance risk, the insurer may classify the entire book as insurance contracts without examining each contract to identify a few non-derivative pure endowments that transfer insignificant insurance risk (see paragraph B25).

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IG Example 1: Application of the definition of an insurance contract		
1.6	Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates guaranteed at inception.	Insurance contract (unless the transfer of insurance risk is insignificant). The contract transfers mortality risk to the insurer at inception, because the insurer might have to pay significant additional benefits for an individual contract if the annuitant elects to take the life-contingent annuity and survives longer than expected (unless the contingent amount is insignificant in all scenarios that have commercial substance).
1.7	Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates prevailing when the annuity begins.	Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Within the scope of IFRS 9 <i>Financial Instruments</i> unless the contract contains a discretionary participation feature. Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all scenarios that have commercial substance).
1.8	Investment contract ^(a) that does not contain a discretionary participation feature.	Within the scope of IFRS 9.
1.9	Investment contract containing a discretionary participation feature.	Paragraph 35 of the IFRS sets out requirements for these contracts, which are excluded from the scope of IFRS 9.
1.10	Investment contract in which payments are contractually linked (with no discretion) to returns on a specified pool of assets held by the issuer.	Within the scope of IFRS 9. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph B4.3.8(g) of IFRS 9).

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IG Example 1: Application of the definition of an insurance contract		
1.11	Contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. The contract may have various legal forms (eg insurance contract, guarantee or letter of credit).	<p>Insurance contract, but within the scope of IFRS 9, not IFRS 4. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 and IAS 32^(b) or IFRS 4 to such financial guarantee contracts. The legal form of the contract does not affect its recognition and measurement.</p> <p>Accounting by the holder of such a contract is excluded from the scope of IFRS 9 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10–12 of IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> apply. Those paragraphs specify criteria to use in developing an accounting policy if no IFRS applies specifically to an item.</p>
1.12	A credit-related guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index.	Not an insurance contract. A derivative within the scope of IFRS 9.

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IG Example 1: Application of the definition of an insurance contract		
1.13	Guarantee fund established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, eg insurance, banking or travel.	The contract that establishes the guarantee fund is an insurance contract (see IG Example 1.11).
1.14	Guarantee fund established by law.	The commitment of participants to contribute to the fund is not established by a contract, so there is no insurance contract. Within the scope of IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> .
1.15	Residual value insurance or residual value guarantee. Guarantee by one party of the fair value at a future date of a non-financial asset held by a beneficiary of the insurance or guarantee.	<p>Insurance contract within the scope of the IFRS (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable).</p> <p>However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and within the scope of IFRS 9.</p> <p>Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 <i>Leases</i>.</p>

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IG Example 1: Application of the definition of an insurance contract		
1.16	Product warranties issued directly by a manufacturer, dealer or retailer.	Insurance contracts, but excluded from the scope of the IFRS (see IAS 18 <i>Revenue</i> and IAS 37).
1.17	Product warranties issued by a third party.	Insurance contracts, no scope exclusion. Same treatment as other insurance contracts.
1.18	Group insurance contract that gives the insurer an enforceable and non-cancellable contractual right to recover all claims paid out of future premiums, with appropriate compensation for the time value of money.	Insurance risk is insignificant. Therefore, the contract is a financial asset within the scope of IFRS 9. Servicing fees are within the scope of IAS 18 (recognise as services are provided, subject to various conditions).
1.19	Catastrophe bond: bond in which principal, interest payments or both are reduced if a specified triggering event occurs and the triggering event does not include a condition that the issuer of the bond suffered a loss.	Financial instrument with embedded derivative within the scope of IFRS 9.

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IG Example 1: Application of the definition of an insurance contract		
1.20	Catastrophe bond: bond in which principal, interest payments or both are reduced significantly if a specified triggering event occurs and the triggering event includes a condition that the issuer of the bond suffered a loss.	<p>The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component.</p> <p>(a) If specified conditions are met, paragraph 10 of the IFRS requires the holder to unbundle the deposit component and apply IFRS 9 to it.</p> <p>(b) The issuer accounts for the insurance component as reinsurance if it uses the bond for that purpose. If the issuer does not use the insurance component as reinsurance, it is not within the scope of the IFRS, which does not address accounting by policyholders for direct insurance contracts.</p> <p>(c) Under paragraph 13 of the IFRS, the holder could continue its existing accounting for the insurance component, unless that involves the practices prohibited by paragraph 14.</p>

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IG Example 1: Application of the definition of an insurance contract		
1.21	An insurance contract issued by an insurer to a defined benefit pension plan covering the employees of the insurer, or of another entity consolidated within the same financial statements as the insurer.	<p>The contract will generally be eliminated from the financial statements, which will include:</p> <ul style="list-style-type: none"> (a) the full amount of the pension obligation under IAS 19 <i>Employee Benefits</i>, with no deduction for the plan's rights under the contract. (b) no liability to policyholders under the contract. (c) the assets backing the contract.
1.22	An insurance contract issued to employees as a result of a defined contribution pension plan. The contractual benefits for employee service in the current and prior periods are not contingent on future service. The insurer also issues similar contracts on the same terms to third parties.	<p>Insurance contract within the scope of the IFRS.</p> <p>If the employer pays part or all of the employee's premiums, the payment by the employer is an employee benefit within the scope of IAS 19. See also IAS 19, paragraphs 39–42 and 104–104D. Furthermore, a 'qualifying insurance policy' as defined in IAS 19 need not meet the definition of an insurance contract in this IFRS.</p>
1.23	Loan contract containing a prepayment fee that is waived if prepayment results from the borrower's death.	<p>Not an insurance contract.</p> <p>Before entering into the contract, the borrower faced no risk corresponding to the prepayment fee. Hence, although the loan contract exposes the lender to mortality risk, it does not transfer a pre-existing risk from the borrower. Thus, the risk associated with the possible waiver on death of the prepayment fee is not insurance risk (paragraphs B12 and B24(b) of Appendix B of the IFRS).</p>

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IG Example 1: Application of the definition of an insurance contract		
1.24	Loan contract that waives repayment of the entire loan balance if the borrower dies.	This contract contains a deposit component (the loan) and an insurance component (waiver of the loan balance on death, equivalent to a cash death benefit). If specified conditions are met, paragraph 10 of the IFRS requires or permits unbundling. If the insurance component is not unbundled, the contract is an insurance contract if the insurance component is significant in relation to the whole contract.
1.25	A contract permits the issuer to deduct a market value adjustment (MVA) from surrender values or death benefits to reflect current market prices for the underlying assets. The contract does not permit an MVA for maturity benefits.	The policyholder obtains an additional survival benefit because no MVA is applied at maturity. That benefit is a pure endowment (see IG Example 1.5). If the risk transferred by that benefit is significant, the contract is an insurance contract.
1.26	A contract permits the issuer to deduct an MVA from surrender values or maturity payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death benefits.	The policyholder obtains an additional death benefit because no MVA is applied on death. If the risk transferred by that benefit is significant, the contract is an insurance contract.

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IG Example 1: Application of the definition of an insurance contract		
1.27	<p>A contract permits the issuer to deduct an MVA from surrender payments to reflect current market prices for the underlying assets. The contract does not permit an MVA for death and maturity benefits. The amount payable on death or maturity is the amount originally invested plus interest.</p>	<p>The policyholder obtains an additional benefit because no MVA is applied on death or maturity. However, that benefit does not transfer insurance risk from the policyholder because it is certain that the policyholder will live or die and the amount payable on death or maturity is adjusted for the time value of money (see paragraph B27 of the IFRS). The contract is an investment contract.</p> <p>This contract combines the two features discussed in IG Examples 1.25 and 1.26. When considered separately, those two features transfer insurance risk. However, when combined, they do not transfer insurance risk. Therefore, it is not appropriate to separate this contract into two 'insurance' components.</p> <p>If the amount payable on death were not adjusted in full for the time value of money, or were adjusted in some other way, the contract might transfer insurance risk. If that insurance risk is significant, the contract is an insurance contract.</p>

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IG Example 1: Application of the definition of an insurance contract		
1.28	A contract meets the definition of an insurance contract. It was issued by one entity in a group (for example a captive insurer) to another entity in the same group.	<p>If the entities present individual or separate financial statements, they treat the contract as an insurance contract in those individual or separate financial statements (see IAS 27 <i>Separate Financial Statements</i>).</p> <p>The transaction is eliminated from the group's consolidated financial statements.</p> <p>If the intragroup contract is reinsured with a third party that is not part of the group, the reinsurance contract is treated as a direct insurance contract in the consolidated financial statements because the intragroup contract is eliminated on consolidation.</p>
1.29	An agreement that entity A will compensate entity B for losses on one or more contracts issued by entity B that do not transfer significant insurance risk.	<p>The contract is an insurance contract if it transfers significant insurance risk from entity B to entity A, even if some or all of the individual contracts do not transfer significant insurance risk to entity B.</p> <p>The contract is a reinsurance contract if any of the contracts issued by entity B are insurance contracts. Otherwise, the contract is a direct insurance contract.</p>
<p>(a) The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract.</p> <p>(b) When an entity applies IFRS 7 <i>Financial Instruments: Disclosures</i>, the reference to IAS 32 is replaced by a reference to IFRS 7.</p>		

Embedded derivatives

IG3 IFRS 9 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the IFRS). Nevertheless, separation and fair value measurement of such an

embedded derivative are not prohibited if the insurer's existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the IFRS.

IG4 IG Example 2 illustrates the treatment of embedded derivatives contained in insurance contracts and investment contracts. The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract. The example does not illustrate all possible circumstances. Throughout the example, the phrase 'fair value measurement is required' indicates that the issuer of the contract is required:

- (a) to measure the embedded derivative at fair value and include changes in its fair value in profit or loss.
- (b) to separate the embedded derivative from the host contract, unless it measures the entire contract at fair value and includes changes in that fair value in profit or loss.

IG Example 2: Embedded derivatives			
Type of embedded derivative		Treatment if embedded in a host insurance contract	Treatment if embedded in a host investment contract
2.1	Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.	The equity-index feature is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder benefits from it only when the insured event occurs. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

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IG Example 2: Embedded derivatives			
2.2	<p>Death benefit that is the greater of:</p> <p>(a) unit value of an investment fund (equal to the amount payable on surrender or maturity); and</p> <p>(b) guaranteed minimum.</p>	<p>Excess of guaranteed minimum over unit value is a death benefit (similar to the payout on a dual trigger contract, see IG Example 2.19). This meets the definition of an insurance contract (unless the life-contingent payments are insignificant) and fair value measurement is not required (but not prohibited).</p>	<p>Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).</p>
2.3	<p>Option to take a life-contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).</p>	<p>The embedded option is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).</p>	<p>Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).</p>

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IG Example 2: Embedded derivatives			
2.4	Embedded guarantee of minimum interest rates in determining surrender or maturity values that is at or out of the money on issue, and not leveraged.	<p>The embedded guarantee is not an insurance contract (unless significant payments are life-contingent^(a)). However, it is closely related to the host contract (paragraph B4.3.8(b) of IFRS 9). Fair value measurement is not required (but not prohibited).</p> <p>If significant payments are life-contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the deposit component (paragraph 10 of the IFRS).</p>	Fair value measurement is not permitted (paragraph B4.3.8(b) of IFRS 9).

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IG Example 2: Embedded derivatives			
		If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be interdependent; if the option to cancel the deposit component cannot be measured separately (ie without considering the other option), both options are regarded as part of the insurance component (paragraph B4.3.8(h) of IFRS 9).	
2.5	Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue, or leveraged.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent). Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).

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IG Example 2: Embedded derivatives			
2.6	Embedded guarantee of minimum annuity payments if the annuity payments are contractually linked to investment returns or asset prices:		
(a)	guarantee relates only to payments that are life-contingent.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
(b)	guarantee relates only to payments that are not life-contingent.	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an unleveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).

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IG Example 2: Embedded derivatives				
	(c)	<p>policyholder can elect to receive life-contingent payments or payments that are not life-contingent, and the guarantee relates to both. When the policyholder makes its election, the issuer cannot adjust the pricing of the life-contingent payments to reflect the risk that the insurer assumes at that time (see paragraph B29 of the IFRS for discussion of contracts with separate accumulation and payout phases).</p>	<p>The embedded option to benefit from a guarantee of life-contingent payments is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).</p> <p>The embedded option to receive payments that are not life-contingent ('the second option') is not an insurance contract. However, because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the insurance contract. In that case, fair value measurement is not required (but not prohibited).</p>	<p>Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).</p>

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IG Example 2: Embedded derivatives			
2.7	Embedded guarantee of minimum equity returns on surrender or maturity.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.8	Equity-linked return available on surrender or maturity.	The embedded derivative is not an insurance contract (unless the equity-linked return is life-contingent to a significant extent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.9	Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity.	The embedded guarantee is an insurance contract (unless the life-contingent payments are insignificant), because the policyholder can benefit from the guarantee only by taking the annuity option (whether annuity rates are set at inception or at the date of annuitisation). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

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IG Example 2: Embedded derivatives			
2.10	<p>Embedded guarantee of minimum equity returns available to the policyholder as either</p> <p>(a) a cash payment,</p> <p>(b) a period-certain annuity or</p> <p>(c) a life-contingent annuity, at annuity rates prevailing at the date of annuitisation.</p>	<p>If the guaranteed payments are not contingent to a significant extent on survival, the option to take the life-contingent annuity does not transfer insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract and is not closely related to the host insurance contract. Fair value measurement is required.</p> <p>If the guaranteed payments are contingent to a significant extent on survival, the guarantee is an insurance contract (similar to a pure endowment). Fair value measurement is not required (but not prohibited).</p>	<p>Fair value measurement is required.</p>

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IG Example 2: Embedded derivatives			
2.11	<p>Embedded guarantee of minimum equity returns available to the policyholder as either</p> <p>(a) a cash payment</p> <p>(b) a period-certain annuity or</p> <p>(c) a life-contingent annuity, at annuity rates set at inception.</p>	<p>The whole contract is an insurance contract from inception (unless the life-contingent payments are insignificant). The option to take the life-contingent annuity is an embedded insurance contract, so fair value measurement is not required (but not prohibited).</p> <p>The option to take the cash payment or the period-certain annuity ('the second option') is not an insurance contract (unless the option is contingent to a significant extent on survival), so it must be separated.</p> <p>However, because the second option and the life-contingent option are alternatives, their fair values are interdependent. If they are so interdependent that the issuer cannot measure the second option separately (ie without considering the life-contingent option), the second option is closely related to the host insurance contract. In that case, fair value measurement is not required (but not prohibited).</p>	Not applicable.

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IG Example 2: Embedded derivatives			
2.12	Policyholder option to surrender a contract for a cash surrender value specified in a schedule (ie not indexed and not accumulating interest).	Fair value measurement is not required (but not prohibited: paragraph 8 of the IFRS). The surrender value may be viewed as a deposit component, but the IFRS does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph B4.3.5(e) of IFRS 9). Otherwise, the surrender option is measured at fair value.
2.13	Policyholder option to surrender a contract for account value based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest-bearing securities), possibly after deducting a surrender charge.	Same as for a cash surrender value (IG Example 2.12).	Same as for a cash surrender value (IG Example 2.12).
2.14	Policyholder option to surrender a contract for a surrender value based on an equity or commodity price or index.	The option is not closely related to the host contract (unless the option is life-contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the IFRS and B4.3.5 (c) and (d) of IFRS 9).	Fair value measurement is required (paragraph B4.3.5 (c) and (d) of IFRS 9)

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IG Example 2: Embedded derivatives			
2.15	Policyholder option to surrender a contract for account value equal to the fair value of a pool of equity investments, possibly after deducting a surrender charge.	If the insurer measures that portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender value differs significantly from account value) (see paragraph B4.3.8(g) of IFRS 9). Otherwise, fair value measurement is required.	If the insurer regards the account value as the amortised cost or fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from account value). Otherwise, fair value measurement is required.
2.16	Contractual feature that provides a return contractually linked (with no discretion) to the return on specified assets.	The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph B4.3.5(f) of IFRS 9). Fair value measurement is required.	Fair value measurement is required.

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IG Example 2: Embedded derivatives			
2.17	Persistency bonus paid at maturity in cash (or as a period-certain annuity).	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the IFRS.) Fair value measurement is required.	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph B4.3.5(b) of IFRS 9). If the option or provision is not closely related to the host instrument, fair value measurement is required.
2.18	Persistency bonus paid at maturity as an enhanced life-contingent annuity.	The embedded derivative is an insurance contract (unless the life-contingent payments are insignificant). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

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IG Example 2: Embedded derivatives			
2.19	Dual trigger contract, eg contract requiring a payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger). The contingent payment is made only if both triggering events occur.	The embedded derivative is an insurance contract (unless the first trigger lacks commercial substance). A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire (paragraph B30 of the IFRS). Therefore, although the remaining exposure is similar to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the first trigger lacks commercial substance).
2.20	Non-guaranteed participating dividend contained in a life insurance contract. The amount is contractually at the discretion of the insurer but is contractually based on the insurer's actual experience on the related block of insurance contracts.	The contract contains a discretionary participation feature, rather than an embedded derivative (paragraph 34 of the IFRS).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).

(a) Payments are life-contingent if they are contingent on death or contingent on survival.

Unbundling a deposit component

IG5 Paragraph 10 of the IFRS requires an insurer to unbundle some insurance contracts that contain a deposit component. IG Example 3 illustrates this requirement. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, unbundling is not required if the insurer recognises all obligations or rights arising from the deposit component.

IG Example 3: Unbundling a deposit component of a reinsurance contract	
<i>Background</i>	
A reinsurance contract has the following features:	
(a)	The cedant pays premiums of CU10 ^(a) every year for five years.
(b)	An experience account is established, equal to 90 per cent of cumulative premiums (including the additional premiums discussed in (c) below) less 90 per cent of cumulative claims.
(c)	If the balance in the experience account is negative (ie cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.
(d)	At the end of the contract, if the experience account balance is positive (ie cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.
(e)	Neither party can cancel the contract before maturity.
(f)	The maximum loss that the reinsurer is required to pay in any period is CU200.
This contract is an insurance contract because it transfers significant insurance risk to the reinsurer. For example, in case 2 discussed below, the reinsurer is required to pay additional benefits with a present value, in year 1, of CU35, which is clearly significant in relation to the contract.	
(a)	In this Implementation Guidance monetary amounts are denominated in 'currency units (CU)'.

IG Example 3: Unbundling a deposit component of a reinsurance contract

The following discussion addresses the accounting by the reinsurer. Similar principles apply to the accounting by the cedant.

Application of requirements: case 1—no claims

If there are no claims, the cedant will receive CU45 in year 5 (90 per cent of the cumulative premiums of CU50). In substance, the cedant has made a loan, which the reinsurer will repay in one instalment of CU45 in year 5.

If the reinsurer's accounting policies require it to recognise its contractual liability to repay the loan to the cedant, unbundling is permitted but not required. However, if the reinsurer's accounting policies would not require it to recognise the liability to repay the loan, the reinsurer is required to unbundle the contract (paragraph 10 of the IFRS).

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows. Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying IFRS 9 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be measured by discounting the future cash flows from the deposit component using a valuation technique. Assume that an appropriate discount rate is 10 per cent and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of CU10 by the cedant is then made up of a loan advance of CU6.7 and an insurance premium of CU3.3.

The reinsurer accounts for the insurance component in the same way that it accounts for a separate insurance contract with an annual premium of CU3.3.

The movements in the loan are shown below.

Year	Opening balance	Interest at 10 per cent	Advance (repayment)	Closing balance
	CU	CU	CU	CU
0	0.00	0.00	6.70	6.70
1	6.70	0.67	6.70	14.07
2	14.07	1.41	6.70	22.18
3	22.18	2.21	6.70	31.09
4	31.09	3.11	6.70	40.90
5	40.90	4.10	(45.00)	0.00
Total		11.50	(11.50)	

IG Example 3: Unbundling a deposit component of a reinsurance contract

Application of requirements: case 2—claim of CU150 in year 1

Consider now what happens if the reinsurer pays a claim of CU150 in year 1. The changes in the experience account, and resulting additional premiums, are as follows.

Year	Premium	Additional premium	Total premium	Cumulative premium	Claims	Cumulative claims	Cumulative premiums less claims	Experience account
	CU	CU	CU	CU	CU	CU	CU	CU
0	10	0	10	10	0	0	10	9
1	10	0	10	20	(150)	(150)	(130)	(117)
2	10	39	49	69	0	(150)	(81)	(73)
3	10	36	46	115	0	(150)	(35)	(31)
4	10	31	41	156	0	(150)	6	6
		<u>106</u>	<u>156</u>		<u>(150)</u>			

Incremental cash flows because of the claim in year 1

The claim in year 1 leads to the following incremental cash flows, compared with case 1:

Year	Additional premium	Claims	Refund in case 2	Refund in case 1	Net incremental cash flow	Present at value 10 per cent
	CU	CU	CU	CU	CU	CU
0	0	0			0	0
1	0	(150)			(150)	(150)
2	39	0			39	35
3	36	0			36	30
4	31	0			31	23
5	0	0	(6)	(45)	39	27
Total	<u>106</u>	<u>(150)</u>	<u>(6)</u>	<u>(45)</u>	<u>(5)</u>	<u>(35)</u>

IG Example 3: Unbundling a deposit component of a reinsurance contract

The incremental cash flows have a present value, in year 1, of CU35 (assuming a discount rate of 10 per cent is appropriate). Applying paragraphs 10–12 of the IFRS, the cedant unbundles the contract and applies IFRS 9 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the CU150 received in year 1 as income, and the incremental payments in years 2–5 as expenses. However, in substance, the reinsurer has paid a claim of CU35 and made a loan of CU115 (CU150 less CU35) that will be repaid in instalments.

The following table shows the changes in the loan balance. The table assumes that the original loan shown in case 1 and the new loan in case 2 met the criteria for offsetting in IAS 32. Amounts shown in the table are rounded.

Loan to (from) the reinsurer

Year	Opening balance	Interest at 10 per cent	Payments per original schedule	Additional payments in case 2	Closing balance
	CU	CU	CU	CU	CU
0	–	–	6	–	6
1	6	1	7	(115)	(101)
2	(101)	(10)	7	39	(65)
3	(65)	(7)	7	36	(29)
4	(29)	(3)	6	31	5
5	5	1	(45)	39	0
Total		(18)	(12)	30	

Shadow accounting

- IG6 Paragraph 30 of the IFRS permits, but does not require, a practice sometimes described as ‘shadow accounting’. IG Example 4 illustrates shadow accounting.
- IG7 Shadow accounting is not the same as fair value hedge accounting under IAS 39 and will not usually have the same effect. Under IAS 39, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of foreign currency risk.
- IG8 Shadow accounting is not applicable for liabilities arising from investment contracts (ie contracts within the scope of IAS 39) because the underlying measurement of those liabilities (including the treatment of related transaction costs) does not depend on asset values or asset returns. However, shadow accounting may be applicable for a discretionary participation feature within an investment contract if the measurement of that feature depends on asset values or asset returns.

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- IG9 Shadow accounting is not applicable if the measurement of an insurance liability is not driven directly by realised gains and losses on assets held. For example, assume that financial assets are measured at fair value and insurance liabilities are measured using a discount rate that reflects current market rates but does not depend directly on the actual assets held. The measurements of the assets and the liability both reflect changes in interest rates, but the measurement of the liability does not depend directly on the carrying amount of the assets held. Therefore, shadow accounting is not applicable and changes in the carrying amount of the liability are recognised in profit or loss because IAS 1 *Presentation of Financial Statements* requires all items of income or expense to be recognised in profit or loss unless an IFRS requires otherwise.
- IG10 Shadow accounting may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an entity uses the revaluation model in IAS 16 *Property, Plant and Equipment*, it recognises changes in the carrying amount of the owner-occupied property in revaluation surplus. If it also elects to use shadow accounting, the changes in the measurement of the insurance liability resulting from revaluations of the property are also recognised in revaluation surplus.

IG Example 4: Shadow accounting
<p><i>Background</i></p> <p>Under some national requirements for some insurance contracts, deferred acquisition costs (DAC) are amortised over the life of the contract as a constant proportion of estimated gross profits (EGP). EGP includes investment returns, including realised (but not unrealised) gains and losses. Interest is applied to both DAC and EGP, to preserve present value relationships. For simplicity, this example ignores interest and ignores re-estimation of EGP.</p> <p>At the inception of a contract, insurer A has DAC of CU20 relating to that contract and the present value, at inception, of EGP is CU100. In other words, DAC is 20 per cent of EGP at inception. Thus, for each CU1 of realised gross profits, insurer A amortises DAC by CU0.20. For example, if insurer A sells assets and recognises a gain of CU10, insurer A amortises DAC by CU2 (20 per cent of CU10).</p> <p>Before adopting IFRSs for the first time in 20X5, insurer A measured financial assets on a cost basis. (Therefore, EGP under those national requirements considers only realised gains and losses.) However, under IFRSs, it classifies its financial assets as measured at fair value through profit or loss.</p> <p>In 20X5 insurer A recognises unrealised gains of CU10 on the assets backing the contract and in 20X6 it sells the assets for an amount equal to their fair value at the end of 20X5.</p>

continued...

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IG Example 4: Shadow accounting*Application of paragraph 30 of the IFRS*

Paragraph 30 of the IFRS permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 20X5 by an additional CU2 (20 per cent of CU10) as a result of the change in the fair value of the assets. Insurer A recognises the additional amortisation of CU2 in profit or loss.

When insurer A sells the assets in 20X6, it makes no further adjustment to DAC.

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain. If insurer A does not adopt shadow accounting, unrealised gains on assets do not affect the amortisation of DAC.

Disclosure**Purpose of this guidance**

IG11 The guidance in paragraphs IG12–IG71 suggests possible ways to apply the disclosure requirements in paragraphs 36–39A of the IFRS. As explained in paragraphs 36 and 38 of the IFRS, the objective of the disclosures is:

- (a) to identify and explain the amounts in an insurer's financial statements arising from insurance contracts; and
- (b) to enable users of those financial statements to evaluate the nature and extent of risks arising from insurance contracts.

IG12 An insurer decides in the light of its circumstances how much detail it gives to satisfy those requirements, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information that has materially different characteristics. It is necessary to strike a balance so that important information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have materially different characteristics. For example:

- (a) a large international insurance group that operates in a wide range of regulatory jurisdictions typically provides disclosures that differ in format, content and detail from those provided by a specialised niche insurer operating in one jurisdiction.
- (b) many insurance contracts have similar characteristics. When no single contract is individually material, a summary by classes of contracts is appropriate.
- (c) information about an individual contract may be material when it is, for example, a significant contributor to an insurer's risk profile.

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To satisfy the requirements, an insurer would not typically need to disclose all the information suggested in the guidance. This guidance does not create additional requirements.

IG13 IAS 1 *Presentation of Financial Statements* requires an entity to 'provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

IG14 For convenience, this Implementation Guidance discusses each disclosure requirement in the IFRS separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures may satisfy more than one requirement. For example, information about the assumptions that have the greatest effect on the measurement of amounts arising from insurance contracts may help to convey information about insurance risk and market risk.

Materiality

IG15 IAS 1 notes that a specific disclosure requirement in an IFRS need not be satisfied if the information is not material. IAS 1 defines materiality as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

IG16 IAS 1 also explains the following:

Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25⁴⁸ that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Explanation of recognised amounts (paragraphs 36 and 37 of the IFRS)

Accounting policies

IG17 IAS 1 requires disclosure of accounting policies and paragraph 37(a) of the IFRS highlights this requirement. In developing disclosures about accounting policies for insurance contracts, an insurer might conclude that it needs to address the treatment of, for example, some or all of the following, if applicable:

- (a) premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums).

⁴⁸ IASC's *Framework for the Preparation and Presentation of Financial Statements* was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraph 25 was superseded by Chapter 3 of the *Conceptual Framework*.

- (b) fees or other charges made to policyholders.
- (c) acquisition costs (including a description of their nature).
- (d) claims incurred (both reported and not reported), claims handling costs (including a description of their nature) and liability adequacy tests (including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in those tests, see paragraphs 15–19 of the IFRS). An insurer might disclose whether insurance liabilities are discounted and, if they are discounted, explain the methodology used.
- (e) the objective of methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models, and the source of information used in the models.
- (f) embedded options and guarantees (including a description of whether (i) the measurement of insurance liabilities reflects the intrinsic value and time value of these items and (ii) their measurement is consistent with observed current market prices).
- (g) discretionary participation features (including a clear statement of how the insurer applies paragraphs 34 and 35 of the IFRS in classifying that feature as a liability or as a component of equity) and other features that permit policyholders to share in investment performance.
- (h) salvage, subrogation or other recoveries from third parties.
- (i) reinsurance held.
- (j) underwriting pools, coinsurance and guarantee fund arrangements.
- (k) insurance contracts acquired in business combinations and portfolio transfers, and the treatment of related intangible assets.
- (l) as required by IAS 1, the judgements, apart from those involving estimations, management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. The classification of discretionary participation features is an example of an accounting policy that might have a significant effect.

IG18 If the financial statements disclose supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, it is appropriate to explain the basis. Disclosures about embedded value methodology might include information similar to that described in paragraph IG17, as well as disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.

Assets, liabilities, income and expense

IG19 Paragraph 37(b) of the IFRS requires an insurer to disclose the assets, liabilities, income and expenses that arise from insurance contracts. If an insurer presents its statement of cash flows using the direct method, paragraph 37(b) requires it

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also to disclose the cash flows that arise from insurance contracts. The IFRS does not require disclosure of specific cash flows. The following paragraphs discuss how an insurer might satisfy those general requirements.

- IG20 IAS 1 requires minimum disclosures in the statement of financial position. An insurer might conclude that, to satisfy those requirements, it needs to present separately in its statement of financial position the following amounts arising from insurance contracts:
- (a) liabilities under insurance contracts and reinsurance contracts issued.
 - (b) assets under insurance contracts and reinsurance contracts issued.
 - (c) assets under reinsurance ceded. Under paragraph 14(d)(i) of the IFRS, these assets are not offset against the related insurance liabilities.
- IG21 Neither IAS 1 nor the IFRS prescribes the descriptions and ordering of the line items presented in the statement of financial position. An insurer could amend the descriptions and ordering to suit the nature of its transactions.
- IG22 IAS 1 requires disclosure, either in the statement of financial position or in the notes, of subclassifications of the line items presented, classified in a manner appropriate to the entity's operations. Appropriate subclassifications of insurance liabilities will depend on the circumstances, but might include items such as:
- (a) unearned premiums.
 - (b) claims reported by policyholders.
 - (c) claims incurred but not reported (IBNR).
 - (d) provisions arising from liability adequacy tests.
 - (e) provisions for future non-participating benefits.
 - (f) liabilities or components of equity relating to discretionary participation features (see paragraphs 34 and 35 of the IFRS). If an insurer classifies these features as a component of equity, disclosure is needed to comply with IAS 1, which requires an entity to disclose 'a description of the nature and purpose of each reserve within equity.'
 - (g) receivables and payables related to insurance contracts (amounts currently due to and from agents, brokers and policyholders related to insurance contracts).
 - (h) non-insurance assets acquired by exercising rights to recoveries.
- IG23 Similar subclassifications may also be appropriate for reinsurance assets, depending on their materiality and other relevant circumstances. For assets under insurance contracts and reinsurance contracts issued, an insurer might conclude that it needs to distinguish:
- (a) deferred acquisition costs; and
 - (b) intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.

- IG23A Paragraph 14 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose the carrying amount of financial assets pledged as collateral for liabilities, the carrying amount of financial assets pledged as collateral for contingent liabilities, and any terms and conditions relating to assets pledged as collateral. In complying with this requirement, an insurer might also conclude that it needs to disclose segregation requirements that are intended to protect policyholders by restricting the use of some of the insurer's assets.
- IG24 IAS 1 lists minimum line items that an entity should present in its statement of comprehensive income. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. An insurer might conclude that, to satisfy these requirements, it needs to present the following amounts in its statement of comprehensive income:
- (a) revenue from insurance contracts issued (without any reduction for reinsurance held).
 - (b) income from contracts with reinsurers.
 - (c) expense for policyholder claims and benefits (without any reduction for reinsurance held).
 - (d) expenses arising from reinsurance held.
- IG25 IAS 18 requires an entity to disclose the amount of each significant category of revenue recognised during the period, and specifically requires disclosure of revenue arising from the rendering of services. Although revenue from insurance contracts is outside the scope of IAS 18, similar disclosures may be appropriate for insurance contracts. The IFRS does not prescribe a particular method for recognising revenue and various models exist:
- (a) Under some models, an insurer recognises premiums earned during the period as revenue and recognises claims arising during the period (including estimates of claims incurred but not reported) as an expense.
 - (b) Under some other models, an insurer recognises premiums received as revenue and at the same time recognises an expense representing the resulting increase in the insurance liability.
 - (c) Under yet other models, an insurer recognises premiums received as deposit receipts. Its revenue includes charges for items such as mortality, and its expenses include the policyholder claims and benefits related to those charges.
- IG26 IAS 1 requires additional disclosure of various items of income and expense. An insurer might conclude that, to satisfy these requirements, it needs to disclose the following additional items, either in its statement of comprehensive income or in the notes:
- (a) acquisition costs (distinguishing those recognised as an expense immediately from the amortisation of deferred acquisition costs).
 - (b) the effect of changes in estimates and assumptions.
 - (c) losses recognised as a result of applying liability adequacy tests.
 - (d) for insurance liabilities measured on a discounted basis:

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- (i) accretion of interest to reflect the passage of time; and
 - (ii) the effect of changes in discount rates.
 - (e) distributions or allocations to holders of contracts that contain discretionary participation features. The portion of profit or loss that relates to any equity component of those contracts is an allocation of profit or loss, not expense or income (paragraph 34(c) of the IFRS).
- IG27 Some insurers present a detailed analysis of the sources of their earnings from insurance activities either in the statement of comprehensive income or in the notes. Such an analysis may provide useful information about both the income and expense of the current period and the risk exposures faced during the period.
- IG28 The items described in paragraph IG26 are not offset against income or expense arising from reinsurance held (paragraph 14(d)(ii) of the IFRS).
- IG29 Paragraph 37(b) also requires specific disclosure about gains or losses recognised on buying reinsurance. This disclosure informs users about gains or losses that may, using some measurement models, arise from imperfect measurements of the underlying direct insurance liability. Furthermore, some measurement models require a cedant to defer some of those gains and losses and amortise them over the period of the related risk exposures, or some other period. Paragraph 37(b) also requires a cedant to disclose information about such deferred gains and losses.
- IG30 If an insurer does not adopt uniform accounting policies for the insurance liabilities of its subsidiaries, it might conclude that it needs to disaggregate the disclosures about amounts reported in its financial statements to give meaningful information about amounts determined using different accounting policies.

Significant assumptions and other sources of estimation uncertainty

- IG31 Paragraph 37(c) of the IFRS requires an insurer to describe the process used to determine the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts and, when practicable, give quantified disclosure of those assumptions. For some disclosures, such as discount rates or assumptions about future trends or general inflation, it may be relatively easy to disclose the assumptions used (aggregated at a reasonable but not excessive level, when necessary). For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions because there are too many, in which case it is more important to describe the process used to generate the assumptions.
- IG32 The description of the process used to determine assumptions might include a summary of the most significant of the following:
- (a) the objective of the assumptions. For example, an insurer might disclose whether the assumptions are intended to be neutral estimates of the most likely or expected outcome ('best estimates') or to provide a given

level of assurance or level of sufficiency. If they are intended to provide a quantitative or qualitative level of assurance, an insurer might disclose that level.

- (b) the source of data used as inputs for the assumptions that have the greatest effect. For example, an insurer might disclose whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, an insurer might disclose the criteria used to determine when the studies are updated and the date of the latest update.
- (c) the extent to which the assumptions are consistent with observable market prices or other published information.
- (d) a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions. If a relationship would normally be expected between experience and future results, an insurer might explain the reasons for using assumptions that differ from past experience and indicate the extent of the difference.
- (e) a description of how the insurer developed assumptions about future trends, such as changes in mortality, healthcare costs or litigation awards.
- (f) an explanation of how the insurer identifies correlations between different assumptions.
- (g) the insurer's policy in making allocations or distributions for contracts with discretionary participation features, the related assumptions that are reflected in the financial statements, the nature and extent of any significant uncertainty about the relative interests of policyholders and shareholders in the unallocated surplus associated with those contracts, and the effect on the financial statements of any changes during the period in that policy or those assumptions.
- (h) the nature and extent of uncertainties affecting specific assumptions. In addition, to comply with paragraphs 125–131 of IAS 1, an insurer may need to disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions could require a material adjustment to the carrying amount of insurance liabilities and insurance assets. Paragraph 129 of IAS 1 gives further guidance on this disclosure.

IG33 The IFRS does not prescribe specific assumptions that would be disclosed, because different assumptions will be more significant for different types of contract.

Changes in assumptions

IG34 Paragraph 37(d) of the IFRS requires an insurer to disclose the effect of changes in assumptions used to measure insurance assets and insurance liabilities. This is consistent with IAS 8, which requires disclosure of the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods.

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- IG35 Assumptions are often interdependent. When this is the case, analysis of changes by assumption may depend on the order in which the analysis is performed and may be arbitrary to some extent. Therefore, the IFRS does not specify a rigid format or content for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure and is appropriate for their particular circumstances. If practicable, an insurer might disclose separately the impact of changes in different assumptions, particularly if changes in some assumptions have an adverse effect and others have a beneficial effect. An insurer might also describe the impact of interdependencies between assumptions and the resulting limitations of any analysis of the effect of changes in assumption.
- IG36 An insurer might disclose the effects of changes in assumptions both before and after reinsurance held, especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.

Changes in insurance liabilities and related items

- IG37 Paragraph 37(e) of the IFRS requires an insurer to disclose reconciliations of changes in insurance liabilities. It also requires disclosure of changes in reinsurance assets. An insurer need not disaggregate those changes into broad classes, but might do that if different forms of analysis are more relevant for different types of liability. The changes might include:
- (a) the carrying amount at the beginning and end of the period.
 - (b) additional insurance liabilities arising during the period.
 - (c) cash paid.
 - (d) income and expense included in profit or loss.
 - (e) liabilities acquired from, or transferred to, other insurers.
 - (f) net exchange differences arising on the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity.
- IG38 An insurer discloses the changes in insurance liabilities and reinsurance assets in all prior periods for which it reports full comparative information.
- IG39 Paragraph 37(e) of the IFRS also requires an insurer to disclose changes in deferred acquisition costs, if applicable. The reconciliation might disclose:
- (a) the carrying amount at the beginning and end of the period.
 - (b) the amounts incurred during the period.
 - (c) the amortisation for the period.
 - (d) impairment losses recognised during the period.
 - (e) other changes categorised by cause and type.

- IG40 An insurer may have recognised intangible assets related to insurance contracts acquired in a business combination or portfolio transfer. IAS 38 *Intangible Assets* contains disclosure requirements for intangible assets, including a requirement to give a reconciliation of changes in intangible assets. The IFRS does not require additional disclosures about these assets.

Nature and extent of risks arising from insurance contracts (paragraphs 38–39A of the IFRS)

- IG41 The disclosures about the nature and extent of risks arising from insurance contracts are based on two foundations:
- (a) There should be a balance between quantitative and qualitative disclosures, enabling users to understand the nature of risk exposures and their potential impact.
 - (b) Disclosures should be consistent with how management perceives its activities and risks, and the objectives, policies and processes that management uses to manage those risks. This approach is likely:
 - (i) to generate information that has more predictive value than information based on assumptions and methods that management does not use, for instance, in considering the insurer's ability to react to adverse situations.
 - (ii) to be more effective in adapting to the continuing change in risk measurement and management techniques and developments in the external environment over time.
- IG42 In developing disclosures to satisfy paragraphs 38–39A of the IFRS, an insurer decides in the light of its circumstances how it would aggregate information to display the overall picture without combining information that has materially different characteristics, so that the information is useful. An insurer might group insurance contracts into broad classes appropriate for the nature of the information to be disclosed, taking into account matters such as the risks covered, the characteristics of the contracts and the measurement basis applied. The broad classes may correspond to classes established for legal or regulatory purposes, but the IFRS does not require this.
- IG43 Under IFRS 8 *Operating Segments*, the identification of reportable segments reflects the way in which management allocates resources and assesses performance. An insurer might adopt a similar approach to identify broad classes of insurance contracts for disclosure purposes, although it might be appropriate to disaggregate disclosures down to the next level. For example, if an insurer identifies life insurance as a reportable segment for IFRS 8, it might be appropriate to report separate information about, say, life insurance, annuities in the accumulation phase and annuities in the payout phase.
- IG44 [Deleted]
- IG45 In identifying broad classes for separate disclosure, an insurer might consider how best to indicate the level of uncertainty associated with the risks underwritten, to inform users whether outcomes are likely to be within a wider or a narrower range. For example, an insurer might disclose information about

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exposures where there are significant amounts of provisions for claims incurred but not reported (IBNR) or where outcomes and risks are unusually difficult to assess (eg asbestos).

- IG46 It may be useful to disclose sufficient information about the broad classes identified to permit a reconciliation to relevant line items in the statement of financial position.
- IG47 Information about the nature and extent of risks arising from insurance contracts is more useful if it highlights any relationship between classes of insurance contracts (and between insurance contracts and other items, such as financial instruments) that can affect those risks. If the effect of any relationship would not be apparent from disclosures required by the IFRS, further disclosure might be useful.

Risk management objectives and policies for mitigating risks arising from insurance contracts

- IG48 Paragraph 39(a) of the IFRS requires an insurer to disclose its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks. Such discussion provides an additional perspective that complements information about contracts outstanding at a particular time. Such disclosure might include information about:

- (a) the structure and organisation of the insurer's risk management function(s), including a discussion of independence and accountability.
- (b) the scope and nature of the insurer's risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing, and how the insurer integrates them into its operating activities. Useful disclosure might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach.
- (c) the insurer's processes for accepting, measuring, monitoring and controlling insurance risks and the underwriting strategy to ensure that there are appropriate risk classification and premium levels.
- (d) the extent to which insurance risks are assessed and managed on an entity-wide basis.
- (e) the methods the insurer employs to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance.
- (f) asset and liability management (ALM) techniques.
- (g) the insurer's processes for managing, monitoring and controlling commitments received (or given) to accept (or contribute) additional debt or equity capital when specified events occur.

These disclosures might be provided both for individual types of risks insured and overall, and might include a combination of narrative descriptions and

specific quantified data, as appropriate to the nature of the insurance contracts and their relative significance to the insurer.

IG49–
IG50

[Deleted]

Insurance risk

IG51

Paragraph 39(c) of the IFRS requires disclosures about insurance risk. Disclosures to satisfy this requirement might build on the following foundations:

- (a) Information about insurance risk might be consistent with (though less detailed than) the information provided internally to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management'.
- (b) Information about risk exposures might report exposures both gross and net of reinsurance (or other risk mitigating elements, such as catastrophe bonds issued or policyholder participation features), especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.
- (c) In reporting quantitative information about insurance risk, an insurer might disclose the methods used, the strengths and limitations of those methods, the assumptions made, and the effect of reinsurance, policyholder participation and other mitigating elements.
- (d) Insurers might classify risk along more than one dimension. For example, life insurers might classify contracts by both the level of mortality risk and the level of investment risk. It may sometimes be convenient to display this information in a matrix format.
- (e) If an insurer's risk exposures at the end of the reporting period are unrepresentative of its exposures during the period, it might be useful to disclose that fact.
- (f) The following disclosures required by paragraph 39 of the IFRS might also be relevant:
 - (i) the sensitivity of profit or loss and equity to changes in variables that have a material effect on them.
 - (ii) concentrations of insurance risk.
 - (iii) the development of prior year insurance liabilities.

IG51A

Disclosures about insurance risk might include:

- (a) information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).

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- (b) information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities, including the general nature of any formula for the participation and the extent of any discretion held by the insurer.
- (c) information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds (see also IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

Sensitivity to insurance risk

- IG52 Paragraph 39(c)(i) of the IFRS requires disclosure about sensitivity to insurance risk. To permit meaningful aggregation, the sensitivity disclosures focus on summary indicators, namely profit or loss and equity. Although sensitivity tests can provide useful information, such tests have limitations. An insurer might disclose the strengths and limitations of sensitivity analyses performed.
- IG52A Paragraph 39A permits two alternative approaches for this disclosure: quantitative disclosure of effects on profit or loss and equity (paragraph 39A(a)) or qualitative disclosure and disclosure about terms and conditions (paragraph 39A(b)). An insurer may provide quantitative disclosures for some insurance risks (in accordance with paragraph 39A(a)), and provide qualitative information about sensitivity and information about terms and conditions (in accordance with paragraph 39A(b)) for other insurance risks.
- IG53 Informative disclosure avoids giving a misleading sensitivity analysis if there are significant non-linearities in sensitivities to variables that have a material effect. For example, if a change of 1 per cent in a variable has a negligible effect, but a change of 1.1 per cent has a material effect, it might be misleading to disclose the effect of a 1 per cent change without further explanation.
- IG53A If an insurer chooses to disclose a quantitative sensitivity analysis in accordance with paragraph 39A(a), and that sensitivity analysis does not reflect significant correlations between key variables, the insurer might explain the effect of those correlations.
- IG54 [Deleted]
- IG54A If an insurer chooses to disclose qualitative information about sensitivity in accordance with paragraph 39A(b), it is required to disclose information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of cash flows. To achieve this, an insurer might disclose the qualitative information suggested by paragraphs IG51–IG58 on insurance risk and paragraphs IG62–IG65G on credit risk, liquidity risk and market risk. As stated in paragraph IG12, an insurer decides in the light of its circumstances how it aggregates information to display the overall picture without combining information with different characteristics. An insurer might conclude that qualitative information needs to be more disaggregated if it is not supplemented with quantitative information.

Concentrations of insurance risk

- IG55 Paragraph 39(c)(ii) of the IFRS refers to the need to disclose concentrations of insurance risk. Such concentration could arise from, for example:
- (a) a single insurance contract, or a small number of related contracts, for instance, when an insurance contract covers low-frequency, high-severity risks such as earthquakes.
 - (b) single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability.
 - (c) exposure to unexpected changes in trends, for example, unexpected changes in human mortality or in policyholder behaviour.
 - (d) exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses.
 - (e) significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts.
 - (f) correlations and interdependencies between different risks.
 - (g) significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows.
 - (h) geographical and sectoral concentrations.
- IG56 Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic.
- IG57 Disclosure about an insurer's historical performance on low-frequency, high-severity risks might be one way to help users to assess cash flow uncertainty associated with those risks. Consider an insurance contract that covers an earthquake that is expected to happen every 50 years, on average. If the insured event occurs during the current contract period, the insurer will report a large loss. If the insured event does not occur during the current period, the insurer will report a profit. Without adequate disclosure of the source of historical profits, it could be misleading for the insurer to report 49 years of reasonable profits, followed by one large loss; users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, it might be useful to describe the extent of the exposure to risks of this kind and the estimated frequency of losses. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies.
- IG58 For regulatory or other reasons, some entities produce special purpose financial reports that show catastrophe or equalisation reserves as liabilities. However, in financial statements prepared using IFRSs, those reserves are not liabilities but

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are a component of equity. Therefore they are subject to the disclosure requirements in IAS 1 for equity. IAS 1 requires an entity to disclose:

- (a) a description of the nature and purpose of each reserve within equity;
- (b) information that enables users to understand the entity's objectives, policies and processes for managing capital; and
- (c) the nature of any externally imposed capital requirements, how those requirements are incorporated into the management of capital and whether during the period it complied with any externally imposed capital requirements to which it is subject.

Claims development

- IG59 Paragraph 39(c)(iii) of the IFRS requires disclosure of claims development information (subject to transitional relief in paragraph 44). Informative disclosure might reconcile this information to amounts reported in the statement of financial position. An insurer might disclose unusual claims expenses or developments separately, allowing users to identify the underlying trends in performance.
- IG60 As explained in paragraph 39(c)(iii) of the IFRS, disclosures about claims development are not required for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year. Therefore, these disclosures are not normally required for most life insurance contracts. Furthermore, claims development disclosure is not normally needed for annuity contracts because each periodic payment arises, in effect, from a separate claim about which there is no uncertainty.
- IG61 IG Example 5 shows one possible format for presenting claims development information. Other possible formats might, for example, present information by accident year rather than underwriting year. Although the example illustrates a format that might be useful if insurance liabilities are discounted, the IFRS does not require discounting (paragraph 25(a) of the IFRS)E

IG Example 5: Disclosure of claims development	
<p>This example illustrates a possible format for a claims development table for a general insurer. The top half of the table shows how the insurer's estimates of total claims for each underwriting year develop over time. For example, at the end of 20X1, the insurer estimated that it would pay claims of CU680 for insured events relating to insurance contracts underwritten in 20X1. By the end of 20X2, the insurer had revised the estimate of cumulative claims (both those paid and those still to be paid) to CU673.</p> <p>The lower half of the table reconciles the cumulative claims to the amount appearing in the statement of financial position. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, if the claims liabilities are discounted, the effect of discounting is deducted to give the carrying amount in the statement of financial position.</p>	

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IG Example 5: Disclosure of claims development						
<i>Underwriting year</i>	<i>20X1</i>	<i>20X2</i>	<i>20X3</i>	<i>20X4</i>	<i>20X5</i>	<i>Total</i>
	CU	CU	CU	CU	CU	CU
Estimate of cumulative claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	(702)	(689)	(570)	(350)	(217)	
	—	82	275	553	751	1,661
Effect of discounting	—	(14)	(68)	(175)	(285)	(542)
Present value recognised in the statement of financial position	—	68	207	378	466	1,119

Credit risk, liquidity risk and market risk

IG62 Paragraph 39(d) of the IFRS requires an insurer to disclose information about credit risk, liquidity risk and market risk that paragraphs 31–42 of IFRS 7 would require if insurance contracts were within its scope. Such disclosure includes:

- (a) summary quantitative data about the insurer's exposure to those risks based on information provided internally to its key management personnel (as defined in IAS 24); and
- (b) to the extent not already covered by the disclosures discussed above, the information described in paragraphs 36–42 of IFRS 7.

The disclosures about credit risk, liquidity risk and market risk may be either provided in the financial statements or incorporated by cross-reference to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time.

IG63 [Deleted]

IG64 Informative disclosure about credit risk, liquidity risk and market risk might include:

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- (a) information about the extent to which features such as policyholder participation features mitigate or compound those risks.
- (b) a summary of significant guarantees, and of the levels at which guarantees of market prices or interest rates are likely to alter the insurer's cash flows.
- (c) the basis for determining investment returns credited to policyholders, such as whether the returns are fixed, based contractually on the return of specified assets or partly or wholly subject to the insurer's discretion.

Credit risk

IG64A Paragraphs 36–38 of IFRS 7 require disclosure about credit risk. Credit risk is defined as 'the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss'. Thus, for an insurance contract, credit risk includes the risk that an insurer incurs a financial loss because a reinsurer defaults on its obligations under the reinsurance contract. Furthermore, disputes with the reinsurer could lead to an impairment of the cedant's reinsurance asset. The risk of such disputes may have an effect similar to credit risk. Thus, similar disclosure might be relevant. Balances due from agents or brokers may also be subject to credit risk.

IG64B A financial guarantee contract reimburses a loss incurred by the holder because a specified debtor fails to make payment when due. The holder is exposed to credit risk, and IFRS 7 requires the holder to provide disclosures about that credit risk. However, from the perspective of the issuer, the risk assumed by the issuer is insurance risk rather than credit risk.

IG65 [Deleted]

IG65A The issuer of a financial guarantee contract provides disclosures complying with IFRS 7 if it applies IFRS 9 in recognising and measuring the contract. If the issuer elects, when permitted by paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring the contract, it provides disclosures complying with IFRS 4. The main implications are as follows:

- (a) IFRS 4 requires disclosure about actual claims compared with previous estimates (claims development), but does not require disclosure of the fair value of the contract.
- (b) IFRS 7 requires disclosure of the fair value of the contract, but does not require disclosure of claims development.

Liquidity risk

IG65B Paragraph 39(a) and (b) of IFRS 7 requires disclosure of a maturity analysis for financial liabilities that shows the remaining contractual maturities. For insurance contracts, the contractual maturity refers to the estimated date when contractually required cash flows will occur. This depends on factors such as when the insured event occurs and the possibility of lapse. However, IFRS 4 permits various existing accounting practices for insurance contracts to continue. As a result, an insurer may not need to make detailed estimates of cash flows to determine the amounts it recognises in the statement of financial position. To avoid requiring detailed cash flow estimates that are not required

for measurement purposes, paragraph 39(d)(i) of IFRS 4 states that an insurer need not provide the maturity analyses required by paragraph 39(a) and (b) of IFRS 7 (ie that show the remaining contractual maturities of insurance contracts) if it discloses an analysis, by estimated timing, of the amounts recognised in the statement of financial position.

- IG65C An insurer might also disclose a summary narrative description of how the maturity analysis (or analysis by estimated timing) flows could change if policyholders exercised lapse or surrender options in different ways. If an insurer considers that lapse behaviour is likely to be sensitive to interest rates, the insurer might disclose that fact and state whether the disclosures about market risk reflect that interdependence.

Market risk

- IG65D Paragraph 40(a) of IFRS 7 requires a sensitivity analysis for each type of market risk at the end of the reporting period, showing the effect of reasonably possible changes in the relevant risk variable on profit or loss or equity. If no reasonably possible change in the relevant risk variable would affect profit or loss or equity, an entity discloses that fact to comply with paragraph 40(a) of IFRS 7. A reasonably possible change in the relevant risk variable might not affect profit or loss in the following examples:

- (a) if a non-life insurance liability is not discounted, changes in market interest rates would not affect profit or loss.
- (b) some insurers may use valuation factors that blend together the effect of various market and non-market assumptions that do not change unless the insurer assesses that its recognised insurance liability is not adequate. In some cases a reasonably possible change in the relevant risk variable would not affect the adequacy of the recognised insurance liability.

- IG65E In some accounting models, a regulator specifies discount rates or other assumptions about market risk variables that the insurer uses in measuring its insurance liabilities and the regulator does not amend those assumptions to reflect current market conditions at all times. In such cases, the insurer might comply with paragraph 40(a) of IFRS 7 by disclosing:

- (a) the effect on profit or loss or equity of a reasonably possible change in the assumption set by the regulator.
- (b) the fact that the assumption set by the regulator would not necessarily change at the same time, by the same amount, or in the same direction, as changes in market prices, or market rates, would imply.

- IG65F An insurer might be able to take action to reduce the effect of changes in market conditions. For example, an insurer may have discretion to change surrender values or maturity benefits, or to vary the amount or timing of policyholder benefits arising from discretionary participation features. Paragraph 40(a) of IFRS 7 does not require entities to consider the potential effect of future management actions that may offset the effect of the disclosed changes in the relevant risk variable. However, paragraph 40(b) of IFRS 7 requires an entity to disclose the methods and assumptions used to prepare the sensitivity analysis.

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To comply with this requirement, an insurer might conclude that it needs to disclose the extent of available management actions and their effect on the sensitivity analysis.

IG65G Some insurers manage sensitivity to market conditions using a method that differs from the method described by paragraph 40(a) of IFRS 7. For example, some insurers use an analysis of the sensitivity of embedded value to changes in market risk. Paragraph 39(d)(ii) of IFRS 4 permits an insurer to use that sensitivity analysis to meet the requirement in paragraph 40(a) of IFRS 7. IFRS 4 and IFRS 7 require an insurer to provide sensitivity analyses for all classes of financial instruments and insurance contracts, but an insurer might use different approaches for different classes. IFRS 4 and IFRS 7 specify the following approaches:

- (a) the sensitivity analysis described in paragraph 40(a) of IFRS 7 for financial instruments or insurance contracts;
- (b) the method described in paragraph 41 of IFRS 7 for financial instruments or insurance contracts; or
- (c) the method permitted by paragraph 39(d)(ii) of IFRS 4 for insurance contracts.

Exposures to market risk under embedded derivatives

IG66 Paragraph 39(e) of the IFRS requires an insurer to disclose information about exposures to market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivative at fair value (for example, guaranteed annuity options and guaranteed minimum death benefits).

IG67 An example of a contract containing a guaranteed annuity option is one in which the policyholder pays a fixed monthly premium for thirty years. At maturity, the policyholder can elect to take either (a) a lump sum equal to the accumulated investment value or (b) a lifetime annuity at a rate guaranteed at inception (ie when the contract started). For policyholders electing to receive the annuity, the insurer could suffer a significant loss if interest rates decline substantially or if the policyholder lives much longer than the average. The insurer is exposed to both market risk and significant insurance risk (mortality risk) and a transfer of insurance risk occurs at inception, because the insurer fixed the price for mortality risk at that date. Therefore, the contract is an insurance contract from inception. Moreover, the embedded guaranteed annuity option itself meets the definition of an insurance contract, and so separation is not required.

IG68 An example of a contract containing minimum guaranteed death benefits is one in which the policyholder pays a monthly premium for 30 years. Most of the premiums are invested in a mutual fund. The rest is used to buy life cover and to cover expenses. On maturity or surrender, the insurer pays the value of the mutual fund units at that date. On death before final maturity, the insurer pays the greater of (a) the current unit value and (b) a fixed amount. This contract could be viewed as a hybrid contract comprising (a) a mutual fund investment

and (b) an embedded life insurance contract that pays a death benefit equal to the fixed amount less the current unit value (but zero if the current unit value is more than the fixed amount).

IG69 Both these embedded derivatives meet the definition of an insurance contract if the insurance risk is significant. However, in both cases market risk may be much more significant than the mortality risk. If interest rates or equity markets fall substantially, these guarantees would be well in the money. Given the long-term nature of the guarantees and the size of the exposures, an insurer might face extremely large losses. Therefore, an insurer might place particular emphasis on disclosures about such exposures.

IG70 Useful disclosures about such exposures might include:

- (a) the sensitivity analysis discussed above.
- (b) information about the levels where these exposures start to have a material effect on the insurer's cash flows (paragraph IG64(b)).
- (c) the fair value of the embedded derivative, although neither the IFRS nor IFRS 7 requires disclosure of that fair value.

Key performance indicators

IG71 Some insurers present disclosures about what they regard as key performance indicators, such as lapse and renewal rates, total sum insured, average cost per claim, average number of claims per contract, new business volumes, claims ratio, expense ratio and combined ratio. The IFRS does not require such disclosures. However, such disclosures might be a useful way for an insurer to explain its financial performance during the period and to give an insight into the risks arising from insurance contracts.

